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THE PREMISES OF EAST-WEST COMMERCIAL RELATIONS

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THE PREMISES OF EAST-WEST COMMERCIAL RELATIONS

TUESDAY, DECEMBER 14, 1982

United States Senate,
Committee on Foreign Relations
and the Congressional Research Service,
Washington, D.C.

The workshop convened, pursuant to notice, at 9:10 a.m., in room EF-100, the Capitol, John P. Hardt, associate director for senior specialists, Congressional Research Service, moderating.

OPENING STATEMENT OF HON. CHARLES PERCY, CHAIRMAN, SENATE FOREIGN RELATIONS COMMITTEE

Senator Percy. I am delighted to have all of you here at these sunrise services. That hot coffee was good this morning after a brisk walk over.

The workshop today and tomorrow on the premises of the East-West commercial relations actually grows out of hearings the Committee on Foreign Relations held last August on U.S. economic policy toward the Soviet Union.

One thing that was very clear from those 2 days of hearings was the tremendous amount of misunderstanding that actually existed as well as a lot of disagreement about the nature of East-West trade and how actually to influence it. We really didn't have a lot of guidelines to go by in some of the new paths that were being charted.

We therefore asked John Hardt of the Congressional Research Service to work with the committee staff in organizing a follow-on workshop. I am very delighted and honored to have my former colleague, Gilbert Gude, alongside me today. We are very grateful and I want to pay tribute at this time to the Congressional Research Service.

Gil, I don't know how any of us could really operate here without the Congressional Research Service. I have depended upon it and relied on it for 16 years and even stolen a few people from your staff, but we have really been very grateful for that close relationship.

I am pleased that we have such knowledgeable and distinguished participants for our three panels, this morning the panel on recent U.S. trade actions, this afternoon on the utility and impact of attempts to restrict U.S. trade and tomorrow morning on the all-important question of prospects for a Western consensus on the East-West policy.

In my own view the key to the whole set of issues is the effectiveness of U.S. trade policy. This, of course, is one of the most difficult aspects of it.

What we are looking for is effectiveness in our trade policy. Put another way, are the East-West trade policy objectives we set for ourselves feasible and are they feasible in themselves, and what kinds of implementation strategies are likely to improve their chances of effectiveness?

I know that many of you will understand because of the lameduck session the Senate is in session now, and we have Cap Weinberger coming over to meet with us on an urgent matter in closed session and will then go in open session with him, that some of our Senators will just have to phase in and out in the conference, but all of us I know will study the proceedings very carefully and are very grateful, indeed, for the participation that you are giving to this conference.

Gil.

OPENING STATEMENT OF HON. GILBERT GUDE, DIRECTOR, CONGRESSIONAL RESEARCH SERVICE, LIBRARY OF CONGRESS

Mr. GUDE. Senator, we so appreciate this request for a workshop on East-West commercial relations. The Congressional Research Service is really a continuum of Congress in carrying out reference and research support and we consider ourselves part of you, our staff, along with your staff and you as members.

We are pleased this morning that we not only have John Hardt, who is going to be moderating the conference, but Stan Heginbotham, Chief of our Foreign Affairs and National Defense Division, also Francis Miko of the Division and Joe Whelan in the opposite corner, Senior Specialist in Soviet-American Relationships and an expert on Soviet negotiating behavior.

This is a part of an ongoing analysis of East-West commercial relations which we have done in conjunction with Senator Percy and Senator Pell in their concerns and interests. We had hearings earlier this year which we supported and a whole series of reports and papers. So we see this as very fruitful for Congress and are so pleased with John Hardt's leadership in this area. John Hardt is our Associate Director for Senior Specialists and his specialty as Senior Specialist is in Soviet economics.

John.

Moderator HARDT. Thank you very much.

Senator PERCY. If I could just comment. I couldn't help but think last night as I sat over in the ABC Nightline studio, even my most loyal and faithful staff members did not stay awake until after the football game because it didn't end till 12:15 last night. [Laughter.]

So I came on about quarter to one and she said I was home in bed, and I am happy to say so was I. We taped it with Sam Donaldson about 11 o'clock. The questions put to me were well now, what do we do with our sanctions on Poland. What do we do? If they give us a little bit, do we then relieve the sanctions or do we ease up the sanctions a little bit? Here we were sitting there and I thought, boy, if we could only have had this conference just a day earlier I would have looked very wise indeed. [Laughter.]

Mr. GUDE. I forgot to introduce Dario Scuka here with the Economic's Division, an analyst in international trade and finance.
John.

STATEMENT OF JOHN P. HARDT, ASSOCIATE DIRECTOR, CONGRESSIONAL RESEARCH SERVICE, LIBRARY OF CONGRESS

RATIONALE OF U.S. SANCTION ACTIONS, COMMENTARY ON PRESIDENT REAGAN'S NOVEMBER 13, 1982, STATEMENT

Moderator HARDT. Thank you very much.

We will start our discussion with a reference to the speech of President Reagan of November 13, the speech in which he lifted the sanctions and indicated a basis of agreement among the Western industrial allies in moving toward resolving the areas of differences on East-West commercial relations.

This speech represents an end to a divisive policy; a divisive policy that was illuminated by the hearings that Senator Percy and Senator Mathias chaired on commercial relations in July and August.

The President's statement ends a very divisive period of policy between the administration and the business community. It provides a basis of moving toward some degree of common policy among the Western industrial economies. The positive aspect of the speech is the ending of the sanctions and the beginning of movement forward toward a unified policy not only within the Federal Establishment, but also with the business community and with our allies.

This speech does pose many problems; these will be threads that go through our discussion as we develop the areas of progress of potential development and important unsettled areas.

Normalized trade dealing with the Soviet Union is a term of art, but it does describe a range within which trade can be conducted, as it is among other trading countries. The limits are set by controls on strategic goods, by limits on credits and business facilitation and it represents other agreed-upon constraints.

But the question that is raised by the statement of the President is how economic developments on the Soviet part are to be considered along with military developments. As you may read from the statement, it equates the military and economic balance and suggests that if the Soviets increase their economic capabilities, then it is a balance that we have to then offset, which is in effect a basis for no trade. This is a philosophy which is often referred to as the zero sum game. This is an approach which in effect, if literally interpreted, implies that any benefit to the Soviet economy is a loss to our interests and to Western interests as a whole.

I suggest you read the President's statement for your own interpretation. Statements in Moscow by Secretary Shultz at the U.S.-U.S.S.R. Trade and Economic Council and other statements by the administration indicate that normalized trade seems to be the policy. But this is a very critical philosophic underpinning for our discussions.

The President further said that longer term studies are underway; that there is a degree of agreement with our allies which provides for stronger measures moving toward what he referred to as a new set of rules for an economic relationship with the Soviet Union. What are the new set of rules to be? They are indicated in part by the reference to the three areas on which there should be studies. There should be a new set of rules on a common energy policy. Needless to say, it is hard to identify a common energy policy at this reading.

There is also reference to the development of effective national security controls. Now those who have followed the deliberations in COCOM and the deliberations on the critical technologies and the nature of the lists are aware that there is a great deal left on the agenda to be determined. There is some agreement on past practices. There is a new approach in the administration's position in strategic controls. How will COCOM proceed toward developing a common policy is an important question.

There is also to be a "harmonization" and a "monitoring of financial relationships." This goes presumably beyond "prudent" credit relations of the Versailles communique. What indeed does this mean? What are preferential credits? What are the bases of monitoring the credit relationships of all of the various countries involved in the Western industrial world supplying and competing for markets in the East?

Each of these are prospective areas for which agreement probably can be attained. But as of the present reading it appears to be a beginning and our discussion here will relate to how that beginning may be utilized.

Now related to each of these areas of study is an overriding consideration that will be discussed this morning, and that is the foreign policy criteria. How is trade used in our relationship with the Soviet Union? We have the Export Administration Act coming up in the 98th Congress and we will have considerable discussion about the President's use of the foreign policy criteria—the basis on which the sanctions and embargoes have been set forth. There is no issue, the testimony and discussion will illustrate this, that is more divisive in the business, the congressional-executive and in the alliance community than the President's use of the foreign policy criteria. So that presumably is an issue implicit in the statement of the President, but for which there will need to be some understanding and some agreement.

Finally there is the question of what the intention, the interests and potentialities are for trade from Moscow's viewpoint. To paraphrase the President "it takes two to trade," and in this sense it is extremely important not only to assess whether or not Mr. Andropov's government is interested in expanding trade, but whether they will be interested in expanding trade with the United States; in what areas, grain or otherwise, and to what extent their trade will be in products that provide a level of Soviet dependency and possible vulnerability. This afternoon we will have considerable insight and light thrown upon this subject; that is, whether there will be trade and on what basis. So the final related assessment is the question of to what extent will Soviet leaders be sensitive to what we perceive as dependency and vulnerability and to what extent might that then affect their foreign and domestic policy.

[Mr. Hardt's prepared statement follows:]

PREMISES UNDERLYING U.S. POLICY ON COMMERCIAL RELATIONS WITH THE U.S.S.R.—A DISCUSSION PAPER BY JOHN P. HARDT AND DONNA GOLD

I. CENTRAL PREMISES

The Reagan and Carter Administration embargoes and sanctions against the Soviet Union raise certain questions about the premises or assumptions underlying these actions, which appear reminiscent of the U.S. policy of economic cold war during the 1950's and 1960's. Economic warfare, however, has not characterized either U.S. or the Western economic policy toward the East since the late 1960's. Instead a broad spectrum of policies, ranging from encouraging interdependence to fostering isolation, has been characteristic of recent policy. This varied East-West commercial policy has been based upon a number of premises accepted to varying degrees in both the United States and the other Western industrial nations. We shall identify these central premises; indicate the range of professionally accepted views; examine some of the questions that would need to be explored in a more detailed inquiry into the nature of these premises; and suggest some tenable assumptions for alternative policy strategies:

1. The Soviet economy exhibits some degree of dependence on Western exports of technology and grain as well as on the provision of credit, and hence is vulnerable to their denial.
2. The United States can either gain control of or coordinate a policy of denying technology, grain or credit to the U.S.S.R. through unified Western action.
3. The economic vulnerability of the Soviet Union to a united Western policy of denial might be effectively used to influence major Soviet domestic and foreign policies.
4. The national interest benefits of the use of trade in Eastern diplomacy will exceed the domestic costs of commercial actions.

(1) Regarding the premise of Soviet dependence on Western exports of technology, grain, and credit and vulnerability to denial:

On the one hand, the availability of Western technology and grain, along with access to government and commercial credit, is becoming increasingly important and might result in significant improvements in the quantity and quality of Soviet economic performance, especially in the long run.

On the other hand, the massive Soviet economy may be expected to adjust to the denial of Western technology, grain, and credit, albeit with some loss of time, quality and volume of output. No absolute interruption of production or economic crisis in the Soviet Union is likely to occur as a direct result of negative Western economic actions.

(2) Regarding the premise of U.S. control or coordination of a Western commercial policy on supplying technology, grain, or credit to the U.S.S.R.:

On the one hand, all members of COCOM and OECD agree on the following: (a) the desirability of established limits on normal commercial relations in order to avoid directly enhancing Soviet military capability; (b) the desirability of a common policy on East-West credit; and (c) the inevitability of an interrelationship between trade and diplomacy in East-West relations.

On the other hand, no member of COCOM or OECD: (a) agrees with the current U.S. administration's definition of strategic goods which includes products and technologies that have only indirect military implications: (b) accepts the view that simply weakening or "punishing" the Soviet economy is an appropriate end in itself; (c) accepts the use of U.S. "foreign policy criteria" in either export licensing or the imposition of embargoes and sanctions. Furthermore, a common credit policy restricting Western competition for Eastern sales in specific areas would seem difficult to devise in a recession-ridden world market.

(3) Regarding the premise of Soviet willingness to alter domestic and foreign policies in order to avoid losing the benefits provided by normal access to Western technology, grain, and credit:

On the one hand, the Soviets deny that external factors would be allowed to influence their sovereign affairs and continue to follow the main lines of their foreign policy in Afghanistan, Angola, Cuba, Eastern Europe, and other foreign areas of Western concern, in spite of economic sanctions and embargoes. While fundamental challenges to Soviet sovereignty, security, or systemic continuity ("the unacceptable S's") appear to be beyond negotiation, leverage, or influence, each political imperative is subject to interpretation. Although it is fair to say that the Soviet Union will not accept changes in policy that fundamentally challenge their sovereignty, security or systemic continuity, the mechanical application of those principles is not an absolute, especially in cases where more or less flexibility may be exhibited depending upon specific circumstances.

While the loss of some output, quality, and timeliness has undoubtedly resulted from recent Western embargoes and other tools of economic warfare, it is not possible to assess with precision their effectiveness in influencing Soviet domestic and foreign policy. No clear attainment of political goals may be attributed to the imposition of negative commercial actions. Certainly, their effectiveness has yet to be proven. Some would argue that if negative measures remained in force for an extended period of time, e.g. a unified Western credit policy over a period of years, they could achieve their intended objectives.

On the other hand, Soviet leaders appear to perceive the economic benefits of improved Western economic ties as critical to economic growth. Therefore, trade and credit policy could potentially be a relatively strong and flexible tool of Western diplomacy, if effectively used within limits.

(4) Regarding the premise that national interest benefits of the use of trade in Eastern diplomacy will exceed the domestic costs of commercial actions:

On the one hand, both the Carter and Reagan administrations justified their use of sanctions and embargoes on the basis of national interest. They each maintained that the benefits derived from such punitive action against the Soviet Union (and later against Poland) in terms of the national interest offset the domestic costs. To be sure they differed on the need for and effectiveness of the grain embargo.

On the other hand, it is widely assumed that the use of foreign policy criteria in the imposition of embargoes and sanctions has had a negative impact on the economies of the United States and its cooperating allies. The Carter grain embargo and industrial technology sanctions related to the Afghanistan invasion and the Reagan energy equipment sanctions related to Polish martial law have been the focal points of these negative economic assessments. The other restrictions—on trade, fishing and transport—enforced by these embargoes and sanctions had little impact.

At a series of hearings of the Senate Foreign Relations Committee held on July 30, August 11 and 12, 1982, a number of questions were raised to clarify these four groups of premises. A draft of this paper had been previously prepared for the Committee and then released for the public at the hearings. This revision is responsive to some of the rich dialogue of the hearings. (See enclosure.) Below are many of the key questions discussed. Selected commentary has been added.

1. Dependency and vulnerability

A. What is the degree of interrelatedness and openness of the Soviet economy as related to the world market? How should it be calculated? How should Soviet foreign trade be valued, in adjusted rubles or dollars? When does interrelatedness and openness become dependence or vulnerability?

The Soviet economy, close to half the size of the United States in GNP, has as its domestic core the economic means to attain most of their economic objectives. As a modernizing economy the efficiency of overall and individual sector performance could be materially enhanced by increasing and selected economic interchange with CMEA, the economically advanced Western countries, and the developing nations. Official statistics undervalue Soviet imports. The correct valuation is subject to different interpretations. This increasing external economic participation or dependence provides a basis for external influence. Vulnerability is a subjective concept.

B. What critical influence may Western technology, equipment, grain and credit have on the timing and quality of Soviet performances in key areas: military capability, agriculture, energy, metallurgy, computer usage, etc.? What are the most likely positive stimuli and negative constraints of East-West trade efforts? How do short and long-run impacts of Western commercial policy compare?

Certain sectors such as automobiles, fertilizer, chemicals, feed grain and livestock may have critical needs for specific imports from particular countries. Sole sources of these requirements, however, have often been short-lived as has been the case with submersible pumps, compressor equipment, and grain. The United States, the one time sole supplier of such goods, now competes with alternative foreign sources. Thus, critical dependence on one Western supplier nation and vulnerability to denial action from that nation, i.e. the United States, has been and is likely to continue to be short-lived. Moreover, few, if any, absolute bottlenecks exist or are likely to arise. Long-run impacts both negative and positive are likely to be considerable when resulting from a uniform western commercial policy. Short-run impacts are less predictable even if Western efforts are coordinated.

C. Is it fair to equate the projected value of Soviet hard currency imports with the enhancement of their military programs that the United States should respond to in our defense planning?

The hard currency earnings from oil, gas, gold, arms sales or other major Soviet exports must be used to finance a number of commercial activities, e.g. payment for energy equipment and other machinery imports, pipe and other metal products, grain and agricultural equipment, debt servicing, claims of client or allied states requiring hard currency and high technology imports. To equate the gross hard currency income with the net expenditures for high technology imports would be hard to sustain.

High technology imports from the United States are a small and decreasing share of trade. Thus, most Soviet high technology imports come from non-U.S. sources.

High technology imports may release resources or increase demand for resources from military support industries. The net effect would vary from pipelines to computerized automotive production facilities. The effectiveness of absorption and utilization of Western technology varies from sector to sector but does not compare with Western counterparts. Therefore, an assumption of a comparable effect in Soviet military capabilities from Western technology imports to Western counterparts experience would be an overstatement.

Relating the small share of Soviet hard currency income from natural gas sales used for high technology imports relevant to defense program requirements in the United States would be even more difficult to quantify.

D. How significant are the dual uses of Western civilian imports for military programs in the U.S.S.R.? What is the potential effectiveness of the diversion of Western imports to military programs?

Safeguards to assure that industrial production is not diverted to military use, e.g. Kama trucks for military use in Afghanistan, has been of increasing interest in the United States. Attention has also been given to restricting the flow of technology by a variety of means, including academic exchanges, in U.S.-U.S.S.R. relations. Attempts to broaden the COCOM perception of the scope of militarily relevant technology and the means of transfer will condition a development of a common Western policy on strategic technology. To date change has occurred primarily in preparation of agendas and discussion rather than application of a radically revised common policy.

E. Is trading with any or all members of CMEA tantamount to trading with the U.S.S.R.? Can economic "punishment" or "reward" of an East European country be effectively transmitted to the U.S.S.R.?

Few Western specialists on CMEA view any member countries as full, direct technology conduits to the U.S.S.R. from the West. Most accept that the substantial degree of integration of CMEA and the strong political military and economic leverage of the Soviet Union assures them of a cooperative policy on sharing the benefits of Western trade. Within this range of perceptions on the degree of coordination of East European import policies are variations by country. The continued "independent country" policy of the United States suggests that Yugoslavia, Hungary, Romania and other CMEA countries will be differentiated in a U.S. discriminating control policy. Other Western countries will all continue to differentiate more than the United States. The degree of preference by Austria for trade with Hungary and by the FRG for inter-German trade with the GDR is likely to be the parameter conditions of variations from "normal" trade.

2. Unified Western policy

A. What are the new aspects of U.S. strategic technology policy under the Reagan administration? Is there still an effective role for COCOM in formulating and administering Western commercial policy with the East?

Over the years there have been broad areas of agreement and disagreement between the West European countries, on the one hand, and the United States, on the other. All agree that "strategic" goods and technologies should be controlled in order to preserve Western security. There is general agreement, even in countries such as France and Italy which are officially discreet about their participation in COCOM, that a mechanism for coordinating Western export policies is necessary. Beyond that, however, there are disagreements about what constitutes a "strategic" good and which ones with which capacities should be restricted. From the beginning the United States has tended toward a broader definition of strategic and has generally sought to control a broader array of goods than most of the Western European countries. In addition, the process of compiling the lists of restricted goods and authorizing exceptions almost inevitably leads to charges that some members are seeking commercial advantages for their firms.

The Carter and Reagan administrations made two proposals for significant changes in COCOM's operations: (1) the incorporation of the "critical technologies" approach in COCOM's licensing guidelines, and (2) a tightening of controls on exports to the Soviet Union.

The critical technologies approach evolves from an initial study by the Defense Science Board completed in 1976. Its chief conclusion was that the direct mechanisms of technology transfer such as technical documentation and training of Eastern personnel that may accompany East-West commercial relations are a more important means of technology transfer than exports of specific products. Instead of focusing on the product being considered for export, the traditional approach to export licensing, the Board recommended focusing on the technology being transferred through a given transaction. Or, as it is often described, a "case" approach should be substituted for the "list" approach. As a follow-on to the study, the Export Administration Act of 1979 mandated the compilation of a list of militarily-critical technologies, which was completed in 1980. This approach has become the central feature of the U.S. position in modifying COCOM procedures.

B. Do Western governments have unified views on the need for government credits and guarantees in Eastern commercial relations? How does one distinguish export subsidies from normal trade financing?

A government-business-banking community partnership characterizes the foreign commercial relations of most, if not all, COCOM and OECD members other than the United States. Government involvement to encourage and facilitate trade includes tariff privileges, credit guarantees and loans, and direct leadership participation at the state to state level, including long-term trade agreements. All government loans and guarantees, including those by the United States, are more preferential than those available in the private commercial banking facilities. The FRG argues that their loan guarantees are not subsidies as they do not incur losses that would be funded from tax revenue. Government financing to ensure competitiveness is viewed by some as normal trade functioning, by others as preferential, export subsidizing. Notwithstanding the differences, an OECD agreement on a common credit policy was reached in June 1982 after the Versailles Summit. While a figure of 12.5 percent was assumed by the United States to be the agreed norm, it appears to have been the European understanding that this norm, as well as any other, would not be officially recognized until the U.S. interest rate dropped to an acceptable level.

C. The postwar economic trade policies were dominated by the superpowers, the Soviet Union in the East, the United States in the West. How has this centralism given way to polycentralism in East-West commercial policy? Are Western governments agreed on the need to differentiate between nations in carrying out their commercial policies with the East? Do Eastern countries differentiate their policy with the West?

In the sixties, the Western industrial countries diverged from U.S. policy and began to develop more independent Eastern policies. With the Sino-Soviet split and increasing polycentricism in Eastern Europe, the divergence of the other Eastern countries' policies from Moscow's views became more pronounced. Chancellor Adenauer's embargo of pipe shipments from the Federal Republic of Germany to the Soviet Union in 1962, which was seconded by U.S. insistence and a NATO embargo order, was probably the end of an era of American East-West commercial policy dominance. For the Germans it was the end of an era of isolating the U.S.S.R. and of insisting on political concessions on such issues as the permanency of German borders and reunification as prior conditions for normal trade.

D. Do all countries view some uses of trade in diplomacy as effective? How about the United States use of foreign policy criteria in licensing? Providing or denying tariff and government credit facilities through legislation? Use of periodic embargoes and sanctions?

An important divergence between the West European countries and the United States concerns the linkage of political and commercial relations with the Communist countries. Whereas the West European countries tend to view political and commercial relations as separate, the United States tends to link them. Some of the West European countries do occasionally link commercial to political relations, but they tend to use "positive" linkages (benefit-penalty) as opposed to the "negative" (penalty-benefit) linkage generally used by the United States. To the Europeans, the norm is the extension of the benefits of normalized trade. Penalties are viewed as the subsequent withholding of benefits. The United States alone uses export controls for foreign policy purposes as well as national security. Thus, West European members have not accepted the American use of foreign policy controls in the COCOM forum.

E. Who bears the cost of embargoes and sanctions? Who receives the benefit? What would a policy of equitably sharing the cost of embargoes and sanctions entail?

Most of the punitive actions taken by the United States in regard to Afghanistan and Poland and seconded by some other countries had at least some negative impact on the Soviet economy and communicated a political message of our concerns to the Soviet leaders and populace. At the same time most of the measures taken were costly to U.S. farm and business groups and to the Federal budget and, at least temporarily, strained relations with U.S. allies. Costs were also borne by farm and business groups in other Western trading nations cooperating with or affected by our actions.

The costs to the United States were unevenly shared, and certainly not equitably. Whether the net costs to the Soviets were greater than the United States is difficult to calculate. The costs explicitly acknowledged by the Soviet Union were certainly less than for the United States. What the benefits would have been to the U.S.S.R. and the United States had relations between the two countries continued at pre-embargo "normalcy" is difficult to calculate. The critical question is the net effect of the sanctions on Soviet economic performance. During the Afghanistan grain embargo the Soviets would unquestionably have done somewhat better in meat output and economic modernization. The Soviets avow that the sanctions have led them to redouble their efforts to regain self-sufficiency at least in wheat. Undoubtedly, the Soviets would have received some benefit from more representative Olympic games. Olympic victories without competition from American and other world-class athletes rang somewhat hollow. Absent the sanctions, our farmers could possibly have received higher prices for their products. Our athletes would have had the satisfaction of representing us well at the Olympics.

The Western industrial and grain exporting nations that complied with U.S. boycotts and embargoes suffered some loss of trade. Western industries in Europe affected by the energy equipment sanctions were threatened by both the U.S. for punitive action resulting from abrogation of contracts and the Soviet Union for loss of income and/or contract penalties for noncompliance.

In the face of embargoes and sanctions, the Soviet Union has sought and obtained alternative supplies in third countries. The beneficiaries were those countries who did not comply but expanded their production and export capabilities to meet the Soviet needs, e.g. Austria and France in industrial equipment and Argentina in grain have been particular cases in point.

3. Soviet response to Western commercial actions

A. How firm is the Soviet commitment to modernization and external trade?

Soviet leadership statements and actions in the Brezhnev era have increasingly advanced the official view that significant growth effects are likely to be achieved from selective Western technology transfer. West European exports of machinery and transport equipment to the U.S.S.R. increased from $294 million in 1965 to almost $2,330 billion in 1980, appearing to illustrate Soviet intentions to increase growth through selective technology transfer from the West.

The long-term effect of Western technology transfers to the Soviet Union will probably be to strengthen the Soviet economy. At the same time, the net effect of such transfers may be to direct Soviet resource allocations toward those sectors of the economy that are the primary recipients of Western technology. Furthermore, the sophisticated nature of domestic investment requirements for projects using Western technology compete with the defense industries and other high-priority sectors.

Foreign technology imports may be likened to a downpayment on economic change; subsequent payments must be made by a selective revision in domestic resource-allocation priorities and traditional forms of planning and management. During the Brezhnev era the growth in the Soviet economy supported substantial simultaneous increases in allocations to consumption, defense, and investment. With slow growth predicted for the 1980s, it appears that choices must be made.

B. Is there a potentiality of a guns/butter/investment debate in the U.S.S.R.? If so, what are the implications for U.S. policy?

Given the secular decline in the Soviet rate of growth in the 1970's and its continuation in the 1980's, the decline in both the growth rate of investment and its share of national income is liable to impose serious constraints on Soviet efforts to modernize key sectors of the economy. Efforts to increase the effectiveness of capital utilization and thus to foster the goal of modernization without significantly increasing investment are unlikely to succeed. Increases in the share of annual growth increments to investment may come from either military or consumption. In the past investment has decreased to sustain these other claimants.

The combination of the short-term effects of the sharply falling draft age increments to the labor force and the sharply rising shares of machine building and metal-working industries required to expand military programs either committed or underway will cause the resource burden of defense to rise sharply. In the leadership succession debate on economic policy these long- and short-term defense burdens affecting economic performance may lead to an unprecedented close look at the military resource claims and debate over change in priorities.

C. Can or will the U.S.S.R. accept the adoption of Western systems of planning and management to improve its economic efficiency?

To date the debates on economic organization and control have been waged within the parameters of Soviet Party guidelines acceptable to the leadership and the local Party apparatus. The dominant position of the Party has not been in question. The Leninist concept of democratic centralism has been kept intact. Whether progressive forms of Western contacts and technology transfer necessary for improved performance can be contained within the traditional Party and governmental bureaucratic frameworks remains to be seen. The ripple effect of modest institutional change may lead to more profound substantive change, especially in the long run as the cumulative effects of institutional changes in Hungary and Poland have indicated.

D. How has the U.S.S.R. responded in the past to Western embargoes, sanctions, explicit trade constraints?

Soviet leaders have been especially sensitive to pressures for change in domestic or foreign policy that were perceived as threats to: their sovereignty, security or system continuity; protection of the sovereign rights of the Soviet state; continuation of the personal leadership and power of individual Party leaders; and preservation of the ideological essentials of their Leninist Party system.

At the same time as they profess the need to keep economics and policy separate, Soviet leaders have used their own economic leverage for influence on the domestic and foreign policies of foreign countries on a number of occasions. Their control system of CMEA and influence system in countries such as Finland, Mongolia, Argentina, and India are based on economic factors. The Soviet Union also finds sovereignty, security, and system continuity to be limiting factors in their influence. Sovereignty is especially reinforced by nationalism in their primary influence areas, including East Europe.

Economic power, especially fortified with political and military power, is a potential source of considerable influence on Soviet policy—if issues of security, system continuity and sovereignty are not brought into fundamental question.

E. What internal Eastern constraints on East-West commercial relations may be relevant to Western partners: hard-currency shortages, domestic investment limitations?

When faced with an unacceptable balance of payments deficit and increased Western debt—as in 1976—Soviet policy has been to take direct and prompt measures to improve their hard currency liquidity. Increased energy, gold and arms sales all are variable foreign economic policies. Reduced imports also have been used to balance accounts.

The natural gas pipelines—domestic and export—and the Baikal Amur railroad (BAM) are current priority project imperatives requiring imports. No other major priority projects have been approved to date for the 1980s. Shortage of domestic investment is certainly a key factor limiting the elevation of major projects to priority level.

F. What long-term commercial commitments with the West are the U.S.S.R. and CMEA likely to accept and honor?

To date the U.S.S.R. has met its contractural obligations, paid its debts, i.e. since the Tsarist debts were not accepted. Although denying the "umbrella" policy—the debtor of last resort for CMEA—they are clearly concerned about all CMEA members avoiding formal default. Aid to Poland and Romania on debt servicing illustrates this point. Implicit subsidies to all CMEA members broadens its implications. Soviet adherence to the terms of commercial contracts have met the norms of world market behavior.

4. *Domestic economic impact of embargoes and sanctions*

A. How large would U.S. grain sales to the U.S.S.R. have been between January 1980 and September 1982 if the non-embargo climate of the pre-Afghan sanctions had prevailed. What effect would those foregone sales have had on farm prices, income and support costs? If the Soviets consider the United States as the residual supplier in 1982-83 for a projected 45 million metric tons purchases, what will the U.S. share of Soviet grain imports be? What imputed costs come from being an unreliable supplier?

From January 1980 to April 1981 U.S. grain sales were limited to the maximum (8mm tons) as stated in U.S.-U.S.S.R. Long-Term Grain Agreement. Sales did not rise to the pre-embargo level of 70 percent of the market share once the embargo had been lifted. According to President Reagan, the U.S. was considered an "unreliable supplier" because of the presumed threat of a reinstitution of the embargoes and/or a violation of grain sale contracts.

The difference between the 70 and 25 percent of the Soviet grain market held by the U.S. from 1979 to 1982 provides an order of magnitude for assessing losses in sales, income, etc. Were the Soviets to import 45 million metric tons (MMT) of grain, as they are projected to do in 1982–83, the United States would then lose out on the sale of approximately 20 MMT of grain considering their pre-embargo share of the market. A 70 percent share would mean a sale of 31.5 MMT, while a 25 percent share would mean a sale of 11.3 MMT. The required government support cost for the purchase of export contracts under the embargo and domestic support prices after the embargo provide parameters for estimating Federal budget outlays. Commerce estimates place 1985 grain sales at $5.8 billion with "markedly improved relations"; the 1980 level of sales during the partial grain embargo was $1.8 billion.

B. What impact did the December 1981 energy equipment sanctions have on U.S. firms in sales, jobs and products? What impact is the June 1982 energy equipment order likely to have on U.S. firms, foreign affiliates, and foreign firms? What specific plants and locations are likely to be affected?

Polish martial law led to the imposition of sanctions by the Reagan administration in December 1981. Affected by this action were U.S. firms providing energy equipment to the U.S.S.R. related to the export gas pipeline. These sanctions were extended to foreign affiliates of U.S. firms and foreign firms using U.S. patents and business in June 1982, and were broadened to embrace all oil and gas related energy equipment. The impact of the expanded sanctions on sales, jobs, profits, etc. was unevenly felt within the United States and abroad. Such places as Illinois, Glasgow (UK), Le Havre (France), Westphalia (FRG) were especially hard hit and may be heavily affected by further actions in the future. A comprehensive assessment of this impact should be made in the future. Such a study would require confidential information, which is presently available only to Executive agencies and private corporations.

C. What policy changes would be required to return the United States to the competitive position status quo ante the embargoes and sanctions for grain and energy equipment? What broader effects have the export control actions had on U.S. market shares in global foreign trade? What effects have export control actions had on the market shares of U.S. wide diameter pipe, semi-conductors, submersible pumps? What would individual case studies of these products and others reveal? How do declining U.S. market shares affect R&D budgets in the United States, the technological advantage and market shares of its international competitors?

Congress had been considering amendments to the Export Administration Act to reverse the June 1982 sanctions [Findley-Bonkers] during the Fall 1982. These were defeated by a narrow margin in the full House. Attention has also been given to the renewal and amendment of the Export Administration Act, which expires in 1983.

II. TENABLE GENERAL ASSUMPTIONS FOR DEVELOPING EAST-WEST COMMERCIAL POLICY STRATEGIES

1. The modernizing Soviet economy is dependent on expanding economic relations with the developed West for improvements in performance in critical economic sectors.—Isolation from the advantages of Western economic interaction would be costly to the Soviet Union in both quantitative and qualitative performance. All Eastern economies are heavily interactive with the West, and more so now than in the past. Without external economic relations, Soviet economic performance would fall further short of their potential.

Projections of Soviet economic growth for the 1980's by Western specialists range from 2 to 4.5 percent per annum. [Wharton Econometrics estimates for 1985 are 3.6 Baseline; 2.6 low; 4.5 high, depending on level of military expenditures, trade with the West, and economic reform.] In spite of poor performance in 1981 and 1982, the Wharton forecast for the Five-Year Plan period is over 3 percent (1981–1985). This may be compared to their outlook for West Europe of 2.5 and East Europe of 1.5 percent growth of GNP for that same time period.

While slow growth as in 1981–82 may continue if natural factors do not improve, such recent growth retarding factors are considered temporary. Whereas some suggest that with an extreme confluence of events (poor weather, critical material and manpower shortages, transportation bottlenecks) might even lead Soviet GNP growth to be negative for short time periods; few, if any, foresee the possibility of economic collapse. In any event, the issue of economic performance is likely to be central during the struggle to succeed Leonid Brezhnev.

2. While there continues to be a fundamental area of Western agreement on trade policy with the East, the U.S. policy of explicit denial of many trade and credit benefits, formulated in response to or directly influenced by specific Soviet political actions, has created a basic division in Western policy. Unity in Western policy is necessary for the effective use of Western trade in diplomacy with the East.—While Eastern trade is an issue of economic importance in West Europe and Japan, for the United States—except for the grain trade—East-West trade is primarily a political issue. Moreover, Western debate on Eastern policy has not stressed building on areas of agreement, but exacerbating areas of conflict. The U.S. debate on fulfillment of energy equipment contracts by European companies has generated heat, but has thrown less light on areas of credit and export control where bases of agreement exist.

3. While implicit and long-term commercial influence remains among the strongest of potential Western influences on Soviet action, the explicit political policy of short-term denial through embargoes and sanctions has been widely perceived as counterproductive, especially in the U.S. farm and European business and governmental communities. Recent U.S. policy emphasizing sanctions and embargoes is likely to continue to be unilateral.—Moreover, the presumed benefits from sanctions and embargoes that purportedly accrue to the general national interest of the United States and of West Europe, actually accrue to third countries. The brunt of the costs are borne by specific Western business and U.S. farming interests, while the beneficiaries included Argentine agriculture and Austrian and French industry.

III. ALTERNATIVE STRATEGIES: RANGE OF OPTIONS

A. Western Policies

1. The strategy employed by the U.S. in the Afghanistan sanctions and embargoes of the Carter administration and their continuation through the Polish martial law sanctions of the Reagan administration may be termed a unilateral, selective and conditional, denial policy.—This trade policy is neo-mercantilist in that the political benefit of the state is considered paramount and may be maximized only at the expense of economic benefits of other states. Moreover, hard currency absorption or denial to the Soviet Union are focused on as ends in policy rather than trade flows. Thus, grain sales are encouraged because they absorb hard currency; equipment sales are discouraged because they generate hard currency.

A cold war U.S. trade and credit policy has been divisive in the West, especially as it included embargoes, economic sanctions, and a marked tightening of export controls. This neo-mercantilist policy appears designed to have a considered, detrimental effect on economic growth, modernization, and consumerism in Eastern Europe. A mercantilist policy keyed to benefiting the power of the U.S. state at the expense of foreign trading partners provides Soviet and other East European leaders the opportunity to blame their economic failures on the United States. Such a discriminatory policy has a greater impact on the economically weaker East European countries than on the Soviet Union and might strengthen the latter's inclination to use force, tighten controls, and reinforce integration in Eastern Europe.

Denying the U.S.S.R. resources is an absolute necessity as they are the fundamental threat to Western security. Any gain to a major adversary is therefore viewed as a loss to the attainment of Western objectives. Mutual benefit—in this view—is precluded since it would be between primary adversaries. A zero sum game approach is thus not only desirable but required.

The West Europeans have not been inclined to join the United States in adopting a cold war or discriminatory policy toward the East. If they did, a unified Western policy of discrimination might lead to a return to the mutual East-West isolation of the 1950's. Such a policy might well make slow economic growth more likely for Eastern and Western Europe and exacerbate East-West tensions.

Those who advocate a policy of unilateral denial have exposed some central objectives that appear to be mutually exclusive: trade reduction with the Soviet Union and use of trade for leverage; reduction of trade with the CMEA-Six on the assumption of a monolithic Eastern bloc and the use of trade to promote polycentrism in both the CMEA and the Warsaw Pact; reduction of imports of energy and other materials from the Soviet Union by the Western industrial nations to limit their hard currency earning capabilities on the assumption that other sources would provide reliable economically competitive supplies. (Although reduced West European energy imports from the U.S.S.R. would mean a reduction in hard currency income to the Communist power center, alternative sources have not been available, let alone reliable and competitive.

(Were Norway able to provide more gas at competitive prices, that independent, apolitical and stable source would resolve the dilemma. But the Norwegians maintain that all the gas that could be extracted by 1990 has already been contracted for.)

Outside the Communist world, one may expect adjustments to occur that offset apparent costs or losses. Grain not sold to the U.S.S.R. will find other markets. Say's Law that supply creates its own demand is operative in this view. Credit not extended to further Soviet developments will be used for other Western projects. This static, full employment assumption tends to justify a policy of embargoes as no short- or long-term change is borne by Western economies, businesses or farms.

In a more dynamic world, however, the Argentinians may plant more corn and export to both the U.S.S.R. and their traditional markets rather than diverting their supplies. In a market with less than a full employment equilibrium, goods and credits denied to the Eastern markets may be under-utilized and production forgone.

2. A unified Western, benefit-penalty policy keyed to areas of critical Soviet dependence has the potential for maximizing Western influence on the Soviet Union by a coordinated effort for providing or withholding critical resources of maximum economic impact on performance.—Two basic commercial policy options for a unified Western policy, available to the United States—(a) a competitive or "Helsinki" policy, or (b) a market or "laissez faire" policy—would have quite different effects on the U.S. effort to forge a common Western policy.

By adhering to a competitive or Helsinki option—following the "competition" criteria of the U.S. Export-Import Bank Act and the letter and spirit of the Helsinki Final Act "Basket Two"—U.S. trade and credit policy could form the basis for a unified Western policy. The Helsinki option has been agreed to by 35 European nations, including the Soviet Union and the United States, and currently reflects West European views. "Basket II" of the Helsinki agreement calls for positive East-West government involvement in: facilitating trade, relieving trade restraints, providing governmental credits and guarantees, encouraging industrial cooperation, and stimulating state to state, private and academic exchanges designed to promote a competitive world trade position. Western European signatories have always been more in tune with these provisions than the United States. The economic organization of their commercial institutions as well as those of the Japanese are designed to implement a governmentally preferential trade policy. These non-U.S. economic institutions are geared for implementing commercial policies that follow the Helsinki agreement, i.e. government intervention: to foster commercial exchange; to facilitate freer flow of economic factors without trade restraints; and to provide for government credit which is more favorable than that which is offered by commercial facilities. Under the Helsinki option Western government involvement to ensure competitiveness would be critical to fostering higher levels of economic growth, modernization, and consumerism in Eastern Europe.

Adopting the Helsinki option in the West might have a beneficial effect on the economic performance of all the nations of the CMEA-Six. The U.S.S.R. tends to be more forthcoming in their trade relations with the CMEA-Six when the West is more involved in CMEA trade than the reverse. Such a preferential policy orientation would offer more benefits to the East European members of CMEA than to the Soviet Union and would likely serve as a counterweight to Soviet influence on the smaller members of CMEA.

A government involved Western credit policy to East Europe might not necessarily involve any new loans to any of the CMEA-Six at this time or in the 1980's, especially from commercial banks. Even with strict conditionality for payment of interest and rescheduled principal, new resources from Western banks might not be available on commercial grounds for Poland, Romania or the other CMEA countries. Yet, some Western governments might be willing to make credit and credit guarantees available to the economically stronger East European countries and under certain political conditions, including some forms of economic reform, to the economically weaker nations such as Poland. In that case, Western commmercial banks might reevaluate their lending policies based on prospects of improved East European planning and management and, consequently, reform might facilitate the application of rules of conditionality in rescheduling and repayment. Specific U.S. bank proposals for joint ventures with Poland currently reflect this possibility which combines economic and political conditionality.

As the Soviet Union is likely to continue to remain creditworthy and expand its net Western debt—in contrast to the CMEA-Six—a more explicit use of the "umbrella' from Moscow might permit more loans to East Europe, e.g. the Soviet Union might individually guarantee other East European loans directly or through CMEA banks. The U.S.S.R. might also directly or indirectly encourage compliance with the terms of Western economic and political conditionality within the CMEA-Six.

Under a second, laissez faire or market option, U.S. trade and credit policy toward East Europe would probably be viewed as discriminatory by East and West Europeans. Without the Western governmental umbrella, commercial relations between Eastern Europe and the West probably could not continue as in the past, given current economic woes in Eastern Europe. For their part, U.S. banks and firms, which generally lack the long experience in dealing with the CMEA countries that some banks and firms in Western Europe have, might conclude that without the U.S. governmental umbrella, they could not deal profitably with Communist countries due to Eastern control of domestic markets and foreign trade monopolies. Moreover, because the Polish debt problems have already dispelled the previously held views of the reliability, stability and credit worthiness of Eastern countries, governmental assurances are more likely to be needed to support trade and credit in the future.

Since European and Japanese governments are heavily involved in all of their trade—East-West, West-West, and North-South trade—a laissez faire orientation would not be likely to develop in the East-West trade. The effect of a combined and compatible European/Japanese Helsinki and U.S. market approach might have the effect of making direct U.S. business participation in the Soviet market less competitive. Indirect participation through foreign based affiliates of U.S. companies would provide a basis of continued competition from offshore facilities but would deny jobs and production to the U.S. domestic economy. Of course, if the energy equipment sanctions through extraterritorial reach, retroactivity and other contractual problems have the chilling effect on U.S. foreign competitiveness feared by the NAM and U.S. Chamber of Commerce, then the indirect, offshore basing variant may also be of limited utility. Some would argue that a sharp restriction of the United States use of "foreign policy criteria" in licensing would be necessary in order to return the U.S. to a competitive position equal with those of other Western nations. Thus, although the laissez faire or market approach may be an attractive concept to the leadership in the United States and preferable to the unilateral, denial strategy due to its potential for effectiveness, it would have its limitations in terms of U.S. commerical benefits. In short, when the government is not in the market with U.S. banks and business they may find the American competitive position inadequate to stay in the market.

As the other Western nations are likely to retain a Helsinki, government intervention, competitive approach, the combination of Western policies might have the effect of ceding Eastern industrial trade to non-U.S. business. A unified Western policy for trade with the East would become a combination of U.S. grain trade and European and Japanese trade in technology. Such a situation would put the United States at an extreme disadvantage because it is difficult to affect commercial policy when not directly and heavily involved. The influence of U.S. policy on terms of credit for industrial trade with the East would therefore be severely limited.

The adoption of the Helsinki approach appears more applicable in the case of the grain trade if the United States is to accomplish the goals stated by President Reagan of reestablishing the United States as the major supplier of grain to the Soviet Union. In order for the United States to be accepted as a "reliable supplier" the Soviets insist that some steps be taken to assure them that U.S. grain sale contracts made will not be abrogated for foreign policy purposes. Some additional steps may be deemed necessary to stimulate the Communist buyers to return the United States to a position of a preferred supplier. A precedent for a selective, competitive grain trade was the extension of agricultural credit facilities to China (which preceded our trade agreement with the PRC.) The extension of agricultural credit guarantees and loans (CCC) to the U.S.S.R. without modifying the Trade Act of 1974 would be politically controversial, but would nonetheless be a means of serving the purposes outlined in President Reagan's speech to the Iowa corn growers on August 2, 1982.

Whether Western trade and credit policies are competitive or laissez faire might also indirectly influence Soviet policy toward East Europe. Western analysts generally consider Soviet energy policy toward East European preferential, as the Soviets supply oil and gas to East European countries at less than the OPEC or world market price and accept a mixture of hard and soft currencies as payment. They conclude that Soviet terms for energy sales confer an implicit, albeit temporary, trade subsidy to East Europe. A competitive Western policy would tend to strengthen East Europe's position vis-a-vis the Soviet Union and might thereby encourage a similar competitive Soviet policy towards East Europe: continued preferential energy pricing and supplies and forebearance on payment of rising East European debts to the U.S.S.R. To the extent that preferential Soviet policy is encouraged toward East Europe by West European competitive policy, this interaction of European and Soviet policy in East Europe may tend to reinforce European inclination toward the Helsinki option.

Although different, the Helsinki option opted for by the Europeans and the market option opted for the United States are not necessarily incompatible. However, without government trade and credit support, U.S. firms would be less competitive than the firms of other Western countries involved in trade with the East. Such differences might encourage the adoption of the German notion of spheres of commercial interest and shared responsibilities for Western countries; e.g. U.S. lead in agriculture, FRG in mining and energy, French and British in chemicals etc.

A combined policy would furthermore involve some political and economic tradeoffs for U.S. policy makers. While a laissez faire policy would allow the United States to be more economically restrictive in dealing with the Soviet Union, it would also force the United States to seek alternative channels outside of the commercial sphere for influencing their Eastern trade. Thus, political influence would take on a heightened role in U.S.-Eastern trade. Conversely, while a policy closer to the Helsinki approach—depending of course on Soviet policy—would allow the United States to compete more effectively with the other Western industrial nations for a share of Eastern trade as the leader of a unified Western policy, it would be more beneficial to the Soviet Union and would include more resource involvement on the part of the United States.

B. Soviet Options

1. Alternative domestic scenarios

The 1980's will present the Soviet Union with economic challenges and opportunities in a degree unprecedented since the introduction of central planning in 1928. According to pessimistic U.S. intelligence estimates of energy and agricultural production and changes in the efficiency of labor and capital, the aggregate growth rate may be halved in the next decade to an average of little more than 2 percent or less in specific years, with negative growth potentially occurring in some years. In contrast to what may be called the growth-reduction school, others in the West conclude that a continuation of a 4 percent growth rate is a reasonable expectation, on the basis of similar data and the Soviet plan figures for the Eleventh Five-Year Plan (1981-85).

This decade of economic crisis will almost inevitably coincide with the Brezhnev succession. The immediate successor may well be one of the current Politburo members but sooner or later a new generation of leaders will come into power. This new generation, which will start to move up during the 1980's, is likely to be different from the current leadership class. It is not only too young to have been involved in the Bolshevik Revolution, but many of its members also lack the personal knowledge of the Stalinist system and the Great Patriotic War. Thus, the 1980's may well be a decade of political change unprecedented since the Lenin succession of the 1920's. As in the past—most notably in the "industrialization debate" of the 1920's, but also during the Stalin and Khrushchev successions—economic issues will undoubtedly be debated. Debate on economic policy is especially likely to become intertwined with the leadership struggle, given the potential for economic crises. While the industrialization debate of the Lenin succession will naturally not be repeated, the succession is likely to prove to be the historical frame of reference for the 1980's. Greater change is possible in the leadership and in economic life than at any time since the late 1920's. The economic course that the Soviet leaders set in the 1980's is likely to be decisive for the nature of leadership in the Soviet Union and for Soviet foreign policy for several decades.

While a policy of muddling through—that is, keeping economic policy as is—is an option for the Soviet leadership, it is liable to result in a significant slowdown in growth and shortfalls in key sectors. Nor would such a policy be likely to advance Soviet international security goals. Likely alternatives for change in economic policy that are available to the Soviet leaders fall into two divergent groups: policies that foster economic modernization and interdependence with the global economy, and neo-Stalinist policies of extreme centralization, tight control, and isolation from the non-Communist world. The modernization/interdependence and the control/security scenarios or tendencies can be described in terms of the differing policies they would entail for national economic development: the allocation of resources among "guns," "butter," and modernization; planning and management; economic relations with the industrialized West; and relations with smaller members of the CMEA. Of the two variants, the modernization and interdependence scenario is liable to yield the better economic results and is more likely to be chosen, if economic improvement is the first priority. If considerations of internal and external security are paramount, the control/security option is more likely to be adopted. While it would appear to advance the internal and external security goals of the Soviet leadership, it would probably not be as beneficial economically as the modernization/interdependence option.

2. Implications for policy with the West

These two domestic economic scenarios have sharply divergent implications for Soviet policy on global outreach, Western Europe, Asia, and the United States. If the modernization/interdependence option is chosen, Soviet policy will be likely to emphasize international cooperation over competition. If the neo-Stalinist control/security option is selected, competition and confrontation with the capitalist countries are liable to be the focus of Soviet policy.

While one of these two tendencies is likely to dominate, some combination of the modernization/interdependence and control/security scenarios is, nonetheless, possible. One feasible combination is a policy of dividing the West; pursuing an economic Westpolitik with Western Europe and Japan and a neo-Stalinist control-security policy with the United States and domestically in the Soviet Union. The two options or tendencies are not mutually exclusive; the component elements of each tend to be mutually reinforcing and to flow from similar policy stimuli. If the U.S. strategy of unilateral, denial policy is followed and leads to a divided Western policy, then to combine policy would seem to be a more feasible option for the U.S.S.R.

Hearings on U.S. Export Controls and the Soviet/European Gas Pipeline (Subcommittee on International Economic Policy, Senate Foreign Relations Committee) July 30, 1982

Panel 1.—The Honorable Lionel H. Olmer, Under Secretary for International Trade, Department of Commerce; and the Honorable James L. Buckley, Under Secretary for Security Assistance, Science and Technology, Department of State.

Panel 2.—Mr. Hugh P. Donaghue, Vice President, Control Data Corporation; Mr. Edward A. Hewett, Senior Economist, The Brookings Institution; Mr. Julius L. Katz, Retired Foreign Service Officer; and Mr. M. A. Wright, Chairman and Chief Executive Officer, of Cameron Iron Works.

"The effectiveness of U.S. Economic Pressures to affect Soviet policies."

Panel 1.—Professor Herbert Levine, Department of Economics, University of Pennsylvania, Philadelphia, PA; and Professor Vladimir G. Treml, Department of Economics, Duke University, Durham, N.C.

Panel 2.—Dr. Charles Wolf, Program Director, International Economic Policy Program, Dean, The Rand Graduate Institute, The Rand Corporation, Santa Monica, CA; Mr. Kempton Jenkins, Vice President, Governmental Affairs, ARMCO, Washington, D.C.; and Mr. Edward A. Hewett, Senior Economist, Brookings Institution, Washington, D.C.

Panel 3.—The Honorable Robert S. Ellsworth, Robert S. Ellsworth and Company, Washington, D.C.; Richard N. Cooper, Professor of International Economics, Center for International Affairs, Harvard University, Cambridge, MA, and The Honorable Myer Rashish, American Enterprise Institute, Washington, D.C.

Panel 4.—Alexander Trowbridge, President, National Association of Manufacturers, Washington, D.C.; Mr. Herbert Stein, Senior Fellow, American Enterprise Institute, Washington, D.C.; and Mr. Thadeus Dukes, Executive Vice President Ingersoll-Rand, New Jersey.

Accompanied by: Mr. Robert J. Seccombe, Vice President, Automated Production Systems Division, Ingersoll-Rand.

[From the New York Times, Nov. 14, 1982]

TRANSCRIPT OF REAGAN SPEECH ON SOVIET UNION

WASHINGTON.—Following is a transcript of President Reagan's radio address today on relations with the Soviet Union, as recorded by The New York Times:

During the campaign two years ago I spoke of the need for the United States to restore the balance in our relationship with the Soviet Union. For too many years we've stood still while the Soviets increased their military strength and expanded their influence from Afghanistan to Ethiopia and beyond. I expressed a belief, which you seemed to share, that it was time for the United States to chart a new course.

Since then, we've embarked upon a buildup of our defense forces in order to strengthen our security and, in turn, to strengthen the prospects for peace. We still have a long way to go, but the fact that we've started on a new course has enabled us to propose the most comprehensive set of proposals for arms reduction and control in more than a quarter of a century.

It's always been my belief that if the Soviets knew we were serious about maintaining our security they might be more willing to negotiate seriously at the bargaining table. In the near future, I will be speaking to you in more detail about this matter of arms control and, more importantly, arms reduction. But right now, I have something in the nature of news I'd like to bring you.

THE ECONOMIC RELATIONSHIP

The balance between the United States and the Soviet Union cannot be measured in weapons and bombers alone. To a large degree, the strength of each nation is also based on economic strength. Unfortunately the West's economic relations with the U.S.S.R. have not always served the national security goals of the alliance. The Soviet Union faces serious economic problems but we, and I mean all of the nations of the free world, have helped the Soviets avoid some hard economic choices by providing preferential terms of trade by allowing them to acquire militarily relevant technology and by providing them a market for their energy resources, even though this creates an excessive dependence on them.

By giving such preferential treatment we've added to our own problems, creating a situation where we have to spend more money on our own defense to keep up with Soviet capabilities which we helped create. Since taking office I have emphasized to our allies the importance of our economic, as well as our political, relationship with the Soviet Union. In July of 1981, at the Economic Summit meeting in Ottawa, Canada, I expressed to the heads of state of the other major Western countries and Japan my belief that we could not continue conducting business as we had. I suggested that we forge a new set of rules for economic relations with the Soviet Union which would put our security concerns foremost. I wasn't successful that time in getting agreement on a common policy.

Then in December of 1981 the Polish Government at Soviet instigation imposed martial law on the Polish people and outlawed the Solidarity Union. This action showed graphically that our hopes for moderation in Soviet behavior were not likely to be fulfilled. In response to that action, I imposed an embargo on selected oil and gas equipment to demonstrate our strong opposition to such actions and to penalize this sector of the Soviet economy which relies heavily on high technology, much of it from the United States.

In June of this year, I extended our embargo to include not only U.S. companies and their products but subsidiaries of U.S. companies abroad and on foreign licensees of U.S. companies. Now it's no secret that our allies didn't agree with this action.

AGREEMENT ON A PLAN

We stepped up our consultations with them in an effort to forge an enduring realistic and security-minded economic policy toward the Soviet Union. These consultations have gone on over a period of months. Well I'm pleased, today, to announce that the industrialized democracies have this morning reached substantial agreement on a plan of action. The understanding we've reached demonstrates that the Western alliance is fundamentally united and intends to give consideration to strategic issues when making decisions on trade with the U.S.S.R.

As a result, we have agreed not to engage in trade arrangements which contribute to the military or strategic advantage of the U.S.S.R. or serve to preferentially aid the heavily militarized Soviet economy. In putting these principles into practice, we will give priority attention to trade in high technology products, including those used in oil and gas production. We will also undertake an urgent study of Western energy alternatives as well as the question of dependence on energy imports from the Soviet Union.

In addition, we've agreed on the following immediate actions:

First, each partner has affirmed that no new contracts for the purchase of Soviet natural gas will be signed or approved during the course of our study of alternative Western sources of energy.

Second, we and our partners will strengthen existing controls on the transfer of strategic items to the Soviet Union.

Third, we will establish without delay procedures for monitoring financial relations with the Soviet Union and will work to harmonize our export credit policies.

The understanding we and our partners have reached, and the actions we are taking, reflect our mutual determination to overcome differences and strengthen our cohesion. I believe this new agreement is a victory for all the allies. It puts in place a much-needed policy in the economic area to compliment our policies in the security area.

THE PROSPECTS FOR PEACE

As I mentioned a moment ago, the United States imposed sanctions against the Soviet Union in order to demonstrate that their policies of oppression would entail substantial costs. Well now that we've achieved an agreement with our allies which provides for stronger and more effective measures, there is no further need for these sanctions and I am lifting them today. The process of restoring a proper balance in relations with the Soviet Union is not ended. It will take time to make up for the losses incurred in past years. But acting together we and our allies are making major progress and I'm happy to say the prospects for peace are brighter.

I have just returned to the White House from the Soviet Embassy where I signed the Book of Condolence for President Brezhnev. New leaders are coming to power in the Soviet Union. If they act in a responsible fashion, they will meet a ready and positive response in the West.

Until next Saturday at this same time, goodbye and God bless you.

Moderator **Hardt**. Now, fortunately, we may start our panel with Dimitri Simes who is going to tell us something about the Soviet perception of trade with the West.

Dimitri Simes has done his academic work in Moscow. He was on the staff of the Institute of World Economies and International Affairs and he is now the executive director of the Soviet and East European Research Program at the School of Advanced International Studies at Johns Hopkins University.

We are delighted to have you.

STATEMENT OF DIMITRI K. SIMES, EXECUTIVE DIRECTOR, SOVIET AND EAST EUROPEAN RESEARCH PROGRAM, JOHNS HOPKINS SCHOOL OF ADVANCED INTERNATIONAL STUDIES, WASHINGTON, D.C.

SOVIET REACTION TO TRADE RESTRICTIONS AND LEVERAGE

Mr. **Simes**. I think it is fairly clear that the Soviets do not like economic sanctions. They have denied that economic sanctions can influence their behavior either in the area of foreign policy or in the area of domestic policy. But this is Soviet rhetoric and only to be expected. The real Soviet response to Western economic pressure is far different.

Since you have my statement, I will take 15 minutes to discuss something slightly different; namely, the Soviet reaction to the Jackson-Vanik amendment. From my point of view it gives you a perfect illustration of how American economic leverage can work, what the limits of this leverage are and what happens when this leverage is misused or abused.

First of all, let me say that as far as I am concerned, the decision to allow several hundred thousand Soviet Jews to emigrate was, from the Kremlin's viewpoint, a real concession, affecting the U.S.S.R.'s domestic and international image.

This looks quite different to the Americans where the right to emigrate is considered God given and where the emigration of citizens is not perceived as a threat to the state. You have to look at

Soviet history to understand what a dramatic breakthrough it was to allow Soviet Jews to leave the Socialist paradise. It obviously created a variety of problems for the Soviets who were completely unused to them.

The first problem concerned the international image of the Soviet Union. Why after 60-plus years of the Soviet regime would Soviet citizens be interested in leaving the U.S.S.R.? Well, of course it could be argued that they were going to their Jewish homeland. But let me remind you that there is a Jewish autonomous republic in the Soviet Union right on the Chinese border, and it could be asked, if Soviet Jews wanted to be with Jews, why did they go to Jerusalem rather than to Birobidzhan.

Second, there was the problem of creating a class of citizens who would look to the West as a place where they would be building their lives and their careers, and these people would be very difficult to control. This again obviously presented a political problem for the Soviet regime.

And finally, the whole system of political controls in the Soviet Union was for decades based on the assumption that those who were fortunate, or unfortunate, enough to be born in the Soviet Union had no way of leaving it. There was no escape. If people disobeyed, they would pay a price.

Now a new situation was created for a considerable number of Soviet intellectuals. And many Soviet intellectuals, particularly in big cities, are Jewish, or at least they are married to Jews, or they have some Jewish connections or they could arrange to receive an invitation from Israel even if they were not Jewish. For this whole category of Soviet citizens a new situation was created.

If they were unhappy with the regime they could say to themselves, OK, we will oppose official policies and we will be fairly bold and if it doesn't work out, if we get into trouble with the authorities, there is always a way out—to go to the West. In short, the opportunity to emigrate from the Soviet Union encouraged people to become bolder and more critical inside the Soviet Union. To allow something like this to develop was not a minor concession on the part of the Soviet regime.

Nevertheless, as you are well aware, the Soviet Union decided to make this concession. Let me outline the reasons as I perceive them.

Reason No. 1: the Soviets clearly miscalculated. They did not expect that so many Soivet Jews and non-Jews would be interested in leaving. I do not believe that in their wildest dreams the Soviets were thinking about 300,000, 400,000, or 500,000 people who would be interested in emigration. So they thought they were dealing with a much more limited and more easily controllable phenomenon.

Second, I think the Soviet Union at that time was genuinely interested in an improved relationship with the United States. We can debate for hours about the reasons for this interest. They could be benign, they could be sinister, or they could be verbose. But, nevertheless, it is fairly clear that the Soviets considered the pursuit of détente with the United States advantageous.

There was an assumption in Moscow that freedom of emigration, or at least some freedom of emigration for Soviet citizens who were

Jewish, was important to the Soviet pursuit of détente. Certainly I think the Soviets believed that the benefits of economic cooperation with the United States were going to be very considerable.

Let me remind you that this was just shortly after the 24th Party Congress where the Soviets essentially decided not to proceed with economic reform, not to cut their defense budget, and not to cut their consumption. On the contrary, they decided to increase their spending on so-called group B (consumer) industries in the Soviet Union.

The funds had to come from somewhere. The Soviets tried a selected arrangement with the West Europeans and the Japanese and it worked to some extent, but the Soviets discovered that the West Europeans and the Japanese were unwilling to make a major economic commitment to the Soviet Union, particularly a multiyear commitment, without some form of American participation. That is why the Soviets felt fairly strongly that the economic connection with the United States was of crucial importance.

Moreover, you have to remember what was offered to the Soviet Union at that time, at least what they thought was offered. They thought that they were offered subsidized, long-term credits which would be guaranteed by the Export-Import Bank and encouraged by the American Government. Much more was obviously involved than the essentially symbolic most-favored-nation status.

The Soviets also thought that they were gaining access to American advanced technology. There were commitments on the part of senior American officials, both from State and from the Department of Commerce, to review lists of forbidden technology and to liberalize the American approach to technology transfer. This was an important consideration for Soviet economic planners and for Soviet officials, in general.

Finally, I think politically American diplomacy initially handled this whole issue extremely well. It handled it extremely well not because of any conscious design, but because of the existing state of affairs. There was a very dedicated hardliner in the Senate who led a campaign against the Soviets, namely, Senator Henry Jackson, and a very skillful diplomat in the White House and later the State Department, Henry Kissinger.

On the one hand there was considerable pressure on emigration because of the introduction of the Jackson-Vanik amendment. On the other hand, however, there were Mr. Nixon and Mr. Kissinger who, according to their own memoires, were coming to the Soviets—let me quote Mr. Nixon on this—and telling them that the administration was absolutely disgusted by the unholy alliance of people who were trying to torpedo United States-Soviet trade. But these people were powerful, they could not be ignored, and the Soviets had to display flexibility to make life a little easier for Mr. Nixon and Mr. Kissinger.

At no point did Nixon and Kissinger make moral judgments about Soviet emigration restrictions. At no point did they tell the Soviets how to reform their domestic practices. They were merely informing the Soviets about the facts of life.

Mr. Donald M. Kendall, chairman of PEPSICO, and Dr. Armand Hammer, chairman of Occidental Petroleum also deserve enormous credit for communicating to the Soviets that the Jackson-Vanik amendment enjoyed broad support in the U.S. Congress and had to be dealt with. It was this situation which indicated to the Soviet leadership that there was an obstacle, a political obstacle, to be addressed in the United States, but that *it could be done without* losing face. They felt that this was a practical problem and not a matter of prestige, not a matter of the U.S.S.R.'s political face.

Then, of course it gradually became fairly clear to the Russians that the situation was quite different than what they had originally thought. First of all, the Jackson-Vanik amendment was passed and that made a difference.

Senator Jackson, as you may remember, made a statement after his discussions with Kissinger in the White House that the Soviets had surrendered under pressure, and that this was the way to deal with them in general. When the Soviets are pressured they kind of like it, because they understand only strength and they know how to react to it. They made concessions on emigration, and, now, they had to be pressured on other issues.

Senator Jackson also revealed confidential understandings between Mr. Gromyko and Mr. Kissinger which essentially put the Kremlin on the spot. It would be very difficult for it to pretend that it was making changes in emigration policies on its own. It was fairly clear that policies were being adjusted in response to American pressure.

But the Jackson-Vanik amendment was not all. There was, of course, the Stevenson amendment which severely restricted Soviet access to American credits, and it made rather clear to the Soviet Government that not only had they been humiliated but they had been offered very little in return. I think the Soviets would have been most unhappy with the Jackson-Vanik amendment anyway, but the Stevenson amendment settled the issue once and for all. There was no incentive for further deliberations. And, as you remember, the Soviets repudiated the United States-Soviet trade agreement signed in 1972.

The moral of this story, as far as I am concerned, is fairly simple. First of all, the United States has some economic leverage even over the most sensitive Soviet policies. Second, this leverage is not unlimited. It is connected with the benefits which the Soviets expect to obtain and with the political problems which concessions may create for the Soviet leadership.

Today the situation is very different than it was in 1972–73. The Soviets feel very strongly that they were mistreated by their partners in détente. Again, we may feel that their perception is entirely unjustified, ridiculous and disgusting. Nevertheless, I believe these are their perceptions and we cannot ignore them.

The Soviets also feel, particularly their leaders feel, that they invested a great deal of personal capital in the process of détente—this was particularly true of Mr. Brezhnev—and they know that their fingers can get burned. It is rather difficult for me to imagine Mr. Andropov at the start of his political career, when he is just trying to consolidate his power, investing his personal prestige in détente with the United States.

Détente was always somewhat controversial in the Soviet Union, and Mr. Brezhnev was able to proceed with it only after he had consolidated his position. Mr. Andropov has to be much more cautious.

Certainly the Soviets are generally disillusioned as far as their trade with the United States and as far as their trade with the West is concerned. Some of their disillusionment has nothing to do with American behavior or West European behavior. They have simply discovered that their economy was less flexible than they thought, that Western economic credits were not a magic wand, and that they had great difficulty absorbing Western technology.

They have also discovered that the items which they need the most are the least available. At least the United States is not prepared to provide these items.

Finally, they have discovered something else. They have discovered how inefficient and weak the West has been in trying to apply economic sanctions against the Soviet Union. Exactly as was the case with the Jackson-Vanik amendment, sanctions have had the most effect before they have been used. It is the fear of sanctions which can really frighten and influence the Soviet leadership.

After the fiasco of the grain embargo and after the debate with the West Europeans over the pipeline, the Soviets have discovered that economic sanctions present a serious inconvenience for them, but they are not mortal to their economy and do not seriously influence their political system.

The Soviets have also discovered that, in a way sanctions can be a blessing in disguise. They were definitely a blessing in disguise as far as the pipleine was concerned because they provided the Soviets with major opportunities to create mischief between the United States and its allies in Europe.

In a way the grain embargo was a blessing in disguise, because it forced the Soviets to take a more critical look at their agricultural situation and at their food problems, and it also proved to the Soviets that there were other suppliers of grain in addition to the United States. As the United States does not like to be too dependent on one supplier of oil, the Soviets do not want to become too dependent on one supplier of grain, especially if this supplier happens to be the Soviet Union's principal adversary, another superpower, the United States.

In short, I am trying to suggest that we do not have the same economic leverage over the Soviets which we had in 1972 and 1973. The leverage still exists. The Soviets do not want to break all of their trade with the United States. The Soviets do understand that if they have a situation of total conflict with the United States it would have a spillover impact on their relations with the West Europeans and the Japanese. So there is still a modicum of Soviet interest in trade with the United States, but I would not overestimate the Soviet interest and I would not overestimate the leverage it provides the United States.

I particularly believe that if we want to use this leverage in any constructive fashion, we have to decide first what exactly we want from the Soviet Union and second what exactly we are willing to offer in return.

It is inconceivable conceptually, and impossible politically, to come to the Soviets and, on one hand, ask them to change their political system and, on the other hand, essentially tell them that the things which they want most are not going to be provided. I am talking about subsidized credits and high technology.

As far as grain is concerned, the Soviets believe that the United States will have to sell grain anyway, and that the sale is not an American favor to the Soviet Union. Among other things, they feel that if they pay hard cash, hard currency for grain, it is already a sufficiently difficult deal for them and they are not prepared to offer additional concessions.

I know this sounds like a rather pessimistic description of the limits of American leverage over the Soviets at this juncture, but I believe that if we want to use this limited leverage effectively we have to start with understanding its margins.

[Mr. Simes' prepared statement follows:]

PREPARED STATEMENT OF DIMITRI K. SIMES

The Soviet Union has consistently taken a declaratory stand against mixing politics and trade, but in practice, the Kremlin is well aware of the inevitable linkage between the two. In a number of instances, the Soviets themselves have used economic relations to indicate their displeasure with one foreign government or another. In the late 1950's, for example, thousands of Soviet specialists were withdrawn from China. Also in the late 1950's, and then again in the late 1960's and early 1970's, Moscow manipulated its level of economic assistance to Egypt to demonstrate its displeasure with Cairo's behavior. Nevertheless, it is true that since Stalin the Soviets have used their economic leverage quietly, without public declarations and without explicit political demands. In no case did they describe such economic pressure as sanctions.

On the other hand, the Soviet Union while denying the existence of Western economic leverage, in fact made some concessions to accommodate its trading partners. The most celebrated examples of this practice were the Soviet decisions in the early 1970's to allow emigration of Volga Germans to the Federal Republic of Germany and Soviet Jews to Israel. These concessions may be perceived as tokens from the American standpoint, however, as far as the regime was concerned, they went to the very heart of the politically sensitive issue of domestic controls. Emigration created considerable problems for the Soviet Union's image as the ideal, socialist society. It provided an escape route for those dissatisfied with the Soviet system, encouraging greater boldness on their part than would otherwise have been imaginable. Finally, emigration created a group of Soviet citizens who saw their future as lying outside the U.S.S.R. and who became a potential fifth column in the eyes of a concerned KGB. Nevertheless, as long as there was the prospect of sizable economic benefits to aid in containing popular distress, and as long as the U.S.S.R.'s partners did not portray the Kremlin's flexibility as a sign of weakness under pressure, the Politburo was willing to be accommodating.

The Soviet leadership is also well aware of the possibility of using trade to create a political constituency in the West. Soviet statements quite openly admit that one purpose of expanded trade is to make détente more stable and, if possible, irreversible. The Soviets observe that Western businessmen are champions of improved relations with the U.S.S.R. and their cultivation is considered important, not only for economic, but also for political reasons.

But the appreciation that trade takes place in a political context and has political implications does not at all mean that the Politburo is prepared to adjust its policy under unconcealed pressure and particularly in response to officially announced economic sanctions. As Yuri Andropov stated at the November 1982 Central Committee Plenum:

"All are equally interested in preserving peace and détente. Therefore, statements in which the readiness for normalization relations is linked with the demand that the Soviet Union pay for this with preliminary concessions in different fields, do not sound serious, to say the least. We shall not agree to this and, properly speaking, we have nothing to cancel: We did not introduce sanctions against anyone, we did not denounce treaties and agreements that were signed and we did not interrupt talks that were started. I should like to stress once more that the Soviet Union stands for accord but this should be sought on the basis of reciprocity and equality." [1]

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[1] As translated in FBIS Daily Report on the Soviet Union, Tuesday, Nov. 23, 1982, p. R 8.

First of all, the Soviets are concerned about losing face. Making concessions in response to what they call "American diktat" is viewed as being beyond the dignity of the U.S.S.R. as a great power. Second, there is a genuine fear of creating a dangerous precedent. The Kremlin does not want the West to believe that it can be pressured into submission. Third, the Soviets claim that economic sanctions against their country have never been effective. It doesn't make much sense, they argue, to make major sacrifices because of economic losses which amount to no more than a temporary inconvenience. Soviet spokesmen admit that sanctions and embargoes obviously hurt, but they argue that they do not hurt enough to make a real economic difference. As Georgy Skorov, Deputy Director of the USA and Canada Institute in Moscow puts it:

"Unfulfillment of concluded contracts can and sometimes does delay the dates of conclusion of this or that contract project. Embargoes without question create certain inconveniences: force us to seek new foreign contractors, require us to speed up our production of substitutes for imports. And a reduction of foreign credits obliges us to rely on paying cash to a greater degree than usual. But all these are mere pinpricks." [2]

Skorov and others explain that the U.S. share of total Soviet imports from Western industrialized countries is .14 percent. "With this kind of ammunition, no serious commander would start a war, even if this is only a trade war," he states.

Soviet official assessments are disputed by a number of American analysts. Nevertheless, even those who argue that the Soviet Union is significantly dependent on imported machinery acknowledge, as has Professor Vladimir Treml, that "About 65 percent of all Soviet imports come from Socialist and Third World countries, and this, of course, limits the effectiveness of the economic leverage available to the West." [3] And as the experience of recent years indicates, the United States, both under the Carter and the Reagan Administrations was unable to develop a united Western front in economic relations with the Soviet Union. That understandably undermines the significance of American economic sanctions in Soviet eyes.

Another reason the Politburo does not take American economic leverage all that seriously is because it no longer perceives the United States as a reliable trading partner. The Soviets complain that they were subjected to so many economic sanctions for so many different reasons that it is very difficult for them to depend on contracts with U.S. firms. According to Georgy Skorov, Poland was used as the last excuse to undermine commerce between the United States and the Soviet Union and according to him: "If there would have been no Poland, then Afghanistan would have been used as an excuse; if not Afghanistan, then the Soviet 'brigade' in Cuba; if not the brigade, then dissidents; if not dissidents, then Ethiopia or Yemen; if not Yemen, then Angola; if not Angola, then the U.S.S.R.'s emigration policy, and so on." [4]

Of course, some of the claims about the relative insignificance of American exports to the Soviet Union may be self-serving. Nevertheless, in the Soviets' rigid, centrally planned economy, being able to rely on prospective supplies is of the utmost importance. Soviet planners are more concerned with being able to know in advance what they would get and at what price, then getting the cheapest and the best possible product.

The Soviet Union does not just talk about the ineffectiveness of U.S. economic pressure. It actively and, in most cases, successfully seeks alternative suppliers. Carter's grain embargo produced in new Soviet grain deals with Argentina and a number of other nations. The United States share of Soviet grain imports has declined considerably. In several instances when the United States has denied the U.S.S.R. machinery and high technology items, it has found that Moscow has been almost immediately able to replace them in Japan and Western Europe.

Another Soviet response to American economic sanctions has been the effort to achieve greater self-sufficiency. Leonid Brezhnev made self-sufficiency in grain one of the principal objectives of his so-called food program. And Andropov, upon his election as General Secretary, promised to continue on the same course. This renewed interest in self-sufficiency goes beyond a desire to make the U.S.S.R. immune to foreign economic pressure. The experience of Poland encouraged the Soviets to avoid over-exposure to the West. And more generally, all Communist nations, with China, no exception, appear to be somewhat disillusioned with the West's ability or unwillingness to make a meaningful contribution to solving their economic problems. Still, economic sanctions serve as a symbolic reminder to the Politburo that interdependence with the West may have considerable costs—both economic and political.

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[2] Moskovskiye Novosti, No. 48, Nov. 28, 1982, p. 5.

[3] Economic relations with the Soviet Union, hearings before the Subcommittee on International Economic Policy and the Committee of Foreign Relations of the U.S. Senate, July 30, 1982, p. 82.

[4] Moskovskiye Novosti, op.cit.

Finally, while the Kremlin does not take pleasure in U.S. economic sanctions, it tries to exploit them to its own political advantage. The recent American-West European debate over the Soviet natural gas pipeline is a perfect illustration of how Soviet propaganda attempted to broaden the transatlantic gap. The Soviets launched a major political offensive to persuade the West Europeans that sanctions were directed not so much against the Soviet Union, but against the West Europeans in order to weaken their export competitiveness and to humiliate them politically.

To sum up, the Soviet response to Western attempts to use economic leverage indicates that the Politburo may be willing to accommodate some political linkages, but Soviet flexibility has limits and it is influenced both by the size of perceived economic benefits and by fear of what it would lose if Moscow is viewed as the weak Giant forced to its knees. Soviet economic problems are severe. In 1983, according to the Chairman of the State Planning Committee, Nikolai Baibakov, Soviet national income will increase by only 2 percent, the lowest rate in Soviet history.[5] If the Soviets want to proceed with economic reform, economic cooperation with the West can provide them with a margin of safety, with a security cushion of sorts during a period of inevitable economic dislocations. Consequently, whatever Moscow claims publically, the West has some economic leverage and the Politburo is prepared to accommodate it within limits. It is in finding these limits and learning to exploit them forthrightly, but tactfully, that lies an important task for U.S. policy makers.

[From the Washington Post, Sept. 26, 1982]

THE BROADER PERILS OF THE "PIPELINE WAR" WITH EUROPE

(By F. Stephen Larrabee and Dimitri K. Simes)

Skirmishes between the United States and its NATO partners over the Siberian natural gas pipeline are more than a family spat. What we are watching now is an important early round in a confrontation that could be the crucial diplomatic event of the 1980s—a U.S.-Soviet battle for the hearts and minds of Europe.

What distinguishes this round of feuding within the Atlantic alliance from earlier, similar episodes is the active participation of a non-member of NATO, the Soviet Union. The Soviets perceive the pipeline issue as an important opportunity to score against the United States in Europe.

From the Politburo's standpoint, "the pipeline war" offers a welcome opening to move Western Europe farther away from the United States and in the direction of unilateral accommodation with the Soviet Union. No other goal appears to stand higher on Moscow's foreign policy agenda than widening the gaps within NATO. And the Soviets believe that they have a good chance to succeed because, as Literaturnaya Gazeta's political commentator Vladimir Lomeyko puts it: "A psychological incompatibility is to a certain extent developing between the West European allies and the hard right-wing group in the United States."

The belief that Ronald Reagan's stubborn pursuit of anti-Soviet sanctions may be a blessing in disguise for Moscow is shared by a growing number of the Kremlin's foreign policy advisers. According to Vadim Zagladin, first deputy chief of the Central Committee's key international department, the Reagan administration's European policy is "not very farsighted." He argues with satisfaction that it hurts America's own interests and "will have far-reaching consequences" detrimental to the United States' influence in Western Europe. Zagladin and his colleagues quite openly admit that this is exactly what they would like to see.

Moscow is realistic enough not to expect a breakup of NATO in the foreseeable future. "Of course, it would be a mistake to think that it is virtually a question of the collapse of the 'Western Alliance' as the sensationalist bourgeois press writes in the heat of the moment," Pravda has cautioned its readers. Both Marxist class analysis of international developments and sophisticated assessments of political realities on both sides of the Atlantic suggest to Russian analysts that the powerful bonds tying the major capitalist nations together will prevent "a divorce," no matter what clashes may take place among individual leaders.

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[5] Izvestiya. November 24, 1982.

So Moscow assumes that NATO will remain a "family." The real issue is, what kind of family? Will the alliance remain a formidable unified adversary able to deal in concert with the Soviet Union? Or will it be reduced to a loose coalition of "quarreling" members with the United States in splendid isolation, assuming a confrontational posture, while the nations of western Europe—disillusioned and frustrated by Washington's inflexibility—try to outdo each other in building bridges to the U.S.S.R.?

Soviet policymakers hope that the NATO family will at least become less willing to follow U.S. leadership, not just on the pipeline, but also on strategy toward the U.S.S.R. in general.

"The more dangerously, the more unceremoniously Washington acts, the more often it beats its head against the wall of reality," Pravda says, predicting that "the omnipotence of Uncle Sam is a mirage and mirages disappear sooner or later." Numerous Soviet officials, including Leonid Brezhnev, have appealed to the pride of the West Europeans, suggesting the U.S. "dictat" should not be allowed to lock the allies into an unnecessary and counterproductive confrontation with the U.S.S.R.

Two European issues are paramount for the Soviets: The NATO decision to modernize its intermediate-range nuclear forces (INF) in Europe and construction of the pipeline. Both are perceived by Moscow primarily in terms of their political implications instead of just their military or economic significance.

In the case of INF modernization, what is at issue is the alliance's ability to override stiff domestic opposition in Europe and to prove to the Russians that NATO is capable of major joint rearmament efforts. In the case of the pipeline, the question is whether the West will succeed in developing a united policy on economic relations with the Soviet Union.

For Moscow, a great deal is riding on the outcome of both issues. If new NATO missiles are deployed in Europe and American sanctions manage, if not to halt the pipeline, then at least to restructure Moscow's access to Western credits and technology, the political "correlation of forces" in Europe will be dramatically altered to Moscow's disadvantage.

American success on both fronts would be a harsh blow to the Kremlin. It would, Moscow fears, mean a return to "containment plus"—plus, in the sense that instability in Eastern Europe, unlike in the '50s, could provide the NATO Alliance with a real rather than a rhetorical opportunity to weaken the Soviet grip over its satellites. But if NATO modernization is torpedoed and the pipeline dispute leads to a transatlantic trade war, the Americans, not the Soviets, will be isolated.

In the '70s, the Soviet Union was not above exploiting American-European tensions. However, it had to weigh this temptation against the interests of maintaining détente with the United States. Now, it seems Moscow has given up on the Reagan administration. While it still shows a willingness to negotiate and does not want to be blamed for arms control deadlocks, the Soviet leadership does not expect any marked improvement in relations with the United States.

As Alexander Bovin, a Soviet commentator with close ties to the Soviet leadership, recently proclaimed: "American [read: Soviet] hopes that the Reagan team would learn as it went along have not been realized."

Bovin was speaking on Soviet television. He went on to make this unusually blunt assessment: "To be frank, I don't believe that any serious agreement can be reached with the Americans as long as Reagan is in the White House." Coming from a man known as a relatively sophisticated moderate, this is an important declaration. And Bovin—not surprisingly—is not alone in this view. Zagladin of the Central Committee has publicly warned against any illusions that relations with the United States can fundamentally improve as long as Reagan remains in power.

Apparently, the Kremlin does not consider the appointment of George Schultz as secretary of state as any grounds for altering this assessment. It is doubtful, in Bovin's view, that Schultz will be able to change the basic attitudes of the Reagan administration. At the same time, Bovin argues—and his views appear to reflect the dominant school of thought in Moscow—Reagan's behavior "opens up new possibilities for limiting and restricting Washington's adverse influence in world affairs."

In the past, there was less cause for concern that the U.S.S.R. would be able to exploit these "internal contradictions" to its advantage. But in the last few years, Soviet propaganda has become much more sophisticated and sensitive to political attitudes in Europe.

A perfect example is the impressive way the Soviets have manipulated the peace issue in Europe, playing on European insecurities and on loose talk from the Reagan administration about "limited nuclear war." Similarly, they are now trying to persuade the Europeans that new pipeline sanctions are not so much directed against Moscow, but are intended "to put the allies on their knees" and to undermine their economies allegedly in order to provide unfair competitive advantages to U.S. business.

It's important to note that though impressive, the Soviet's political offensive in Europe does not amount to a comprehensive strategy, because the Brezhnev leadership is unable to define priorities and to make tough choices.

If it could be more bold, the politburo might announce, for instance, Soviet readiness to cut SS-20 numbers by, let us say, half, if NATO agreed to cancel its modernization plans. This would be a masterful stroke. If the Soviet offer was rejected, as the Reagan administration would undoubtedly recommend, the European peace movement would gain new momentum, probably making deployment of American missiles impossible at no cost to the Russians. West German and other European leaders convinced the United States to accept the inevitable and to make a deal, the Kremlin would succeed in keeping an SS-20 force larger than the one that originally prompted Helmut Schmidt to warn about the dangers of nuclear imbalance in the European theater five years ago.

Such boldness is apparently beyond the Kremlin's reach. Still, on a tactical level the Soviets have learned to make such arguments with considerable skill. Much of the credit for this effective diplomacy belongs to a new generation of Soviet foreign policy professionals who operate just below the Politburo level.

These "new look" Soviet officials are a far cry from the leaden, humorless heavies who spoke publicly for the Soviet Union in the past. They have had good international training. They are well traveled in the West and they are at ease with the European media. A special "International Information Department" was created in the Central Committee several years ago to coordinate the Soviets' propaganda offensive.

Its chief, Leonid Zamyatin, who acts as the spokesman for the Kremlin, was rated highly by American reporters during a joint press conference with Jody Powell during the 1979 U.S.-Soviet summit between Leonid Brezhnev and Jimmy Carter. Zamyatin's deputy, Valentin Falin, a former ambassador to West Germany and one of the brightest and most experienced Soviet diplomats, is specifically entrusted with appealing to the West European public.

The department of international information works in close cooperation with other Soviet party and government agencies. Vadim Zagladin and his associate, Anatoliy Chernyaev, help the Zamyatin-Falin team from the Central Committee's influential international department. At the Foreign Ministry, two deputies, Georgy Kornienko and Anatoly Kovalev have reputations for professionalism and high visibility profiles. Even the general staff is involved. Col.-Gen. Nikolai Chevrov specializes in attending international conferences and granting interviews to the foreign press rebutting American claims of a Soviet threat and proclaiming his country's dedication to peace.

All these officials regularly travel across Europe, impressing their Western interlocutors with their relaxed manner, their mastery of facts and languages and their unfailing willingness to repeat the Soviet commitment to avoiding the "madness" of "unwinnable" nuclear war. They supervise the production of propaganda material filled with data regarding Soviet and Western military capabilities and designed to prove that the Reagan administration has no grounds for talking about the U.S.S.R.'s military superiority.

The quality of much of this material has impressed Western officials and experts. "Of course their data is selective, and their assessment of it is biased. But in comparison with [U.S. Defense Secretary Caspar] Weinberger's releases, Soviet productions do not look bad at all," according to one West German journalist. According to the same German, "Since naturally everybody expects the Russians to be more primitive and propagandistic than the Americans, by simply scoring equally, the Soviets achieve a political victory of sorts."

But if the Soviets deserve credit for more sophisticated propaganda, the more important fact should not be missed: Moscow's new prospects in Western Europe are due primarily not to its own master strokes but to Washington's serious errors.

What disturbs American friends in Europe and delights the Soviets is the Reagan administration's apparent inability to understand that there is a difference between exercising true leadership and issuing orders, particularly when it is clear in advance that these orders will be ignored, annoying both sides in the process.

The collapse of Bonn's left-of-center coalition will not significantly change the situation. Helmut Kohl, the Christian Democratic leader and likely chancellor in a new government, is on record supporting the Schmidt cabinet's opposition to U.S. sanctions. And the foreign minister in a new center-right government is likely to be the same Hans Dietrich Genscher who was Schmidt's foreign minister, and who is known to be as critical as Schmidt of Reagan's pipeline policies. If the Christian

Democrats had been in power when the Siberian gas project was initiated, they might have been more sympathetic to American arguments. But at this late date the Christian Democrats see no possibility of abandoning the pipeline regardless of President Reagan's appeals and pressures.

Neither the United States nor its European critics have a monopoly on wisdom and virtue. But the administration does not need to share European optimism about the potential for success of negotiations to control nuclear weapons to appreciate that for many allies vigorous pursuit of arms control is a domestic precondition for rearmament.

The administration does not have to be persuaded that economic cooperation with the Soviet Union serves the West to understand that sanctions against the allies is not the way to restrict trade with America's main adversary.

The administration is not obliged to abandon Reagan's beautiful dream of putting Soviet communism on the ash heap of history to realize that presenting it as a practical U.S. policy in a speech to the British parliament does not bring the dream any closer to fruition.

On the contrary, there is a real danger that, challenged to join an all-out ideological crusade, the allies may shy away from the much more urgent and realistic task of disciplining Soviet power and promoting peaceful change in Eastern Europe.

In short, regardless of whether the administration is closer to the truth than the Europeans in its assumptions of what track to take toward the Soviets, a refusal to face the limits imposed by the real world is ultimately self-defeating. Reagan may believe that he has a mandate to conduct a hard line policy toward the Soviet Union. But surely, he has no mandate—and hopefully no intention—to conduct such a policy in the face of inescapable evidence that the policy actually helps the Kremlin.

The United States has legitimate grievances against the allies, whose behavior can be infuriating. They will never offer the United States more than a troubled partnership. But this partnership is indispensable to U.S. security.

It would be tragic if the most anti-Soviet American government since the establishment of diplomatic relations with Moscow 50 years ago ended up promoting unilateral West European détente with its archrival.

Moderator HARDT. Thank you very much, Dimitri.

Now if we can turn our attention to the views of the business community to the question of trade with the East. Howard Lewis is the assistant vice president for international economic affairs of the National Association of Manufacturers. He has worked extensively in the field of international management and international trade. He is a graduate of Trinity College and his doctoral work was at Claremont Graduate School.

STATEMENT OF HOWARD LEWIS III, ASSISTANT VICE PRESIDENT, NATIONAL ASSOCIATION OF MANUFACTURERS, WASHINGTON, D.C.

DOMESTIC U.S. COMMERCIAL IMPACT OF SANCTIONS

Mr. LEWIS. As Dr. Hardt indicated, I have prepared a paper that has been distributed and therefore I will summarize the basic points that have been brought up in the paper. The points are pretty straightforward.

One, I think any discussion of East-West trade controls has to recognize that we control trade with a lot more nations than the Communist bloc countries. So we can't just think of trade controls as an East-West issue.

The second point I would like to discuss today is that controls do definitely affect the perception of the U.S. manufacturing community as reliable suppliers.

The third point I would like to go over is that controls affect the ability of U.S. companies to run their subsidiaries overseas and I think ultimately you have to realize that this affects the value, the worth if you want to call it that, of the subsidiary to the U.S. parent.

Finally, I think we have to discuss the fact that our export control policies are much more of a disincentive to our manufacturing community than the control policies of our allies.

I have discussed those four points in the paper and I would like to turn to them in a minute, but before doing that I would like to cover a point that I haven't brought out in the paper, namely, the importance of manufactured exports to the U.S. economy. I suspect your concern or lack of concern about the four points that I have just listed above is largely influenced by the degree to which you see manufactured exports as important or not important to what we are trying to do with our economy today.

Some facts. Manufactured exports are the key determinant of our overall export growth in this country. Manufactured exports equal 3½ times the amount of agricultural exports from this country. I suspect if you would go out on the streets and do a poll and ask people do we export more agricultural goods or more manufactured goods, that the average person would say agricultural goods. That isn't the case.

Manufactured exports are the largest earner of income for our balance-of-payments account. Sixty-five percent of the $236 billion of U.S. merchandise exports comes from manufactured exports, and 67 percent of the direct investment earnings that are listed under the services line of our balance of payments account are in fact the earnings of U.S. petroleum companies and U.S. manufacturing companies overseas.

So clearly how competitive our manufacturing companies are internationally and not just in the United States is very critical to how we are going to improve our balance of payments or attempt to improve our balance of payments.

Finally, just to complete my list of facts, the Census Bureau and Commerce Department came out earlier this year with a study which, when you did the arithmetic in the tables in the back of the study, showed that 30 percent of the net increase in private sector employment between 1977 and 1980 came from manufactured exports—30 percent from manufactured exports alone. That doesn't include services or anything else.

The point I am trying to make is not necessarily that NAM [National Association of Manufacturers] is an important organization because we represent manufacturers, but rather that we should probably be careful about any premature celebration of the postindustrial society. I am not saying that the service sector is not important. Obviously it is very important to our economy and obviously it should be a very important element in our trade policy as the USTR [United States Trade Representative] has indicated and as they are negotiating in Geneva and elsewhere on service barriers.

However, I hope the points that I have brought out about manufacturing exports illustrate that we must also be very concerned about the policies of our Government that affect our industrial competitiveness in this country. I certainly think that for the manufacturing companies which export from this country or try to operate overseas subsidiaries that controls are one of the major disincentives. There is a great deal of interest in the business community this year obviously since the Export Administration Act is going to be renewed.

Having set the stage, I would like to now turn to the points that I have brought out in my paper.

The first impact of controls that we need to discuss is the issue of the reliability or the perception, and I think the perception is more important sometimes than reality, of the United States as a reliable supplier. The ability of American firms to enter into long-term contracts is absolutely crucial. The ability of any nation's firms to enter into long-term contracts is crucial, but it is especially crucial for the United States.

We depend on capital goods exports to carry our trade account. We had a $46 billion surplus in the capital goods account in 1981 and exports in capital goods projects involve long-term commitments where contracts are signed and the delivery of goods may be years after the contract is signed. So the dependability and the reliability and the perception of that by overseas customers is absolutely critical.

In my paper I have developed a table which outlines some of the "zigs and zags" in U.S. commercial policy over the last half a dozen years on several different capital goods types of projects. As you can see from that table, it is not always the executive branch that causes the problems. Congress has certainly caused modifications and cancellations of licenses as well as the executive branch.

I think, whether we like it or not, we have to realize that controls do affect the perception of U.S. companies as suppliers. For example, I would like to illustrate how the recent pipeline controls affected the semiconductor industry which obviously did not have anything to do with the immediate controls at issue.

The semiconductor industry felt that the precedents being established in the recent controls jeopardized their cross-licensing agreements throughout the world. The issue being raised by the industry was whether the direct product of U.S. technology which was exported under a general license could be subject to future foreign policy controls after the technology transfer had taken place.

The pipeline controls certainly seemed to assert such jurisdiction, and a number of semiconductor firms felt that their ongoing cross-licensing agreements were brought into jeopardy by this policy on the pipeline controls. That is an example of the indirect impact that some controls, in this case the East-West trade controls, can have on our trade policy in totally different parts of the world that have nothing to do with the immediate issue at hand.

I think Stan also has another example of the type of net that is cast by our control policies and the type of things that are caught up in it.

In addition to raising questions about the reliability of U.S. companies, I think controls also raise the issue of the degree to which foreign subsidiaries of U.S. companies, notice I said foreign subsidiaries of U.S. companies—they are incorporated overseas in the host country and they are foreign companies—can be controlled and the value of them to the U.S. parent.

The Export Administration Act provides very sweeping powers for the President in this regard, and I have outlined in my paper some of the issues that have been raised about the amendment to the 1977 International Economic Emergency Powers Act.

But in reality the ability of the United States to control or to have an extraterritorial application of our control policies really depends on the willingness of others to tolerate these controls. This is not a new issue. It is not something that was invented with the pipeline controls of the last several months. You can go back and find several other examples. In 1965 the United States attempted to prevent the Fruehauf in France from shipping truck bodies to China. The French Government put the Fruehauf subsidiary in France into receivership and China got the truck bodies.

Our allies, to some extent, are willing to put up with the extraterritorial nature of our reexport controls for military or strategic reasons. Their own control laws are, after all, based on national security criteria. But I think what the Fruehauf case and others such as the pipeline illustrate that they are far less tolerant of the extraterritorial application of our foreign policy controls. In fact, they aren't tolerant at all of them.

I think the repercussions of our control policies are particularly disturbing—and here I am moving to my third point—in light of the control policies of other nations on their exporters and on their overseas subsidiaries.

In this regard I find it very interesting that last Friday at the subcommittee meeting on export controls of the President's Export Council a paper was presented that compared U.S. policies to the policies of other nations. I have attached a copy of that to the paper. Let me just tick down a few of the examples they cited where our competitors don't have nearly the export disincentive that we do.

For instance, with two minor exceptions, competitors have no foreign policy controls. They have no sweeping extraterritorial application of their controls. They have no denial list. They have no retroactivity interference with existing contracts unless there is a national emergency. In many cases our competitors have no export licenses for exports going to many countries. There is only one country that is so treated by the United States and that is Canada.

The point here is that controls are an important disincentive for U.S. exporters and for U.S. international companies operating overseas. There is a particular disincentive when you compare what we face to what our competitors face.

Obviously the question for the business community that is being discussed right now is where do we go from here in terms of possibly changing or attempting to change U.S. control policies. This is clearly a question that Congress is going to answer in 1983 with the reauthorization of the Export Administration Act.

There are a number of options being discussed, and I emphasize the word "discussed" within the business community right now. I have attached a memorandum I have prepared for a meeting of our International Trade Committee which outlines some of these options.

Just to briefly list them, there is the possibility of tighter drafting of section 6 of the Export Administration Act, the foreign policy controls. There is the possibility of compensation. There is the possibility of changing the decisionmaking process that goes into implementing the control. There is the possibility of a congressional veto. Another possibility is the congressional approval of any new foreign policy controls. Finally, there is some discussion of import controls for foreign policy reasons.

I want to emphasize that these are not all policies that are enthusiastically greeted by every member of the National Association of Manufacturers or the business community. In fact, in a couple of cases there is a great deal of debate and dissention over some of the points I have just listed. But these options that I have just listed do give you some flavor for the type of thinking that is going on in the private sector right now.

In conclusion, when I was hard pressed to prepare this paper last week for this meeting today I came across the "light switch article" by George Shultz that he wrote when he was president of Bechtel. I thought about just handing this out and saying that it summarizes the business point of view far better than I could and Mr. Shultz's views are far more important than mine. As a compromise I wrote my own paper, but I also attached Mr. Shultz's article to the end of it.

I would call your attention to that. I think that is a very accurate summary of what the business community feels is necessary in our control policies in the future.

Thank you.

[Mr. Lewis' prepared statement follows:]

PREPARED STATEMENT OF HOWARD LEWIS III

The recent furor over the Soviet natural gas pipeline clearly demonstrates that the issue of East-West trade can hardly be discussed today without reference to the subject of U.S. foreign policy export controls. It is important to remember, however, that for many U.S. manufacturing companies the implications of U.S. control policies extend well beyond East-West commercial relations.

Over the past half dozen years, U.S. foreign policy controls have been applied in almost every region of the world from Eastern Europe to Latin America and to products ranging from stuffed bears to commercial aircraft. There exists a real worry among our trading partners that the precedent established today for trade with the U.S.S.R. can be used tomorrow in other commercial transactions with other nations.

The U.S. manufacturing community has watched this expansion of foreign policy controls with growing concern. These concerns have been accurately summarized in an often quoted article (copy attached) by Secretary of State, George P. Shultz, written while he was President of the Bechtel Corporation. Mr. Shultz states in this article:

"It takes a long time to go abroad, get positioned and learn about how to do things. A considerable investment is made on both sides of the transaction. . . . In this process the company develops what the government may regard as a bargaining chip. But if our government then takes that bargaining chip and spends it, where does that leave the company? The company has lost out and its commercial relationship deteriorates."

In short, foreign policy controls are more than just a short term inconvenience for U.S. business. They have long term implications for U.S. international competitiveness.

It would certainly be useful in the debate over U.S. foreign policy controls if a specific figure could be given for the economic costs of these controls. While some research efforts have been made in this regard, it is impossible to generate any genuinely useful information with such an approach. How can we possibly measure the impact and costs of a telegram sent by the Government of Kuwait to other Arab nations urging them not to purchase American commercial aircraft as a protest against U.S. policies toward the Arab world, exemplified in part by U.S. embargoes against Libya, Syria, and Iraq? Any attempt to quantify the impact of U.S. foreign policy controls would not pick up this type of negative development and therefore would underestimate the overall cost to U.S. commercial interests. A more useful approach to assessing the impact of these controls is a general examination of the ways in which they adversely affect the reliability of U.S. companies in exporting from the United States and in operating their overseas subsidiaries.

RELIABILITY OF U.S. COMPANIES AS SUPPLIERS

Export contracts and license agreements of U.S. manufacturers often involve commitments for the delivery of goods and technology years in advance of when a particular transaction eventually takes place. The ability of U.S. firms to enter into and fulfill long term contracts is absolutely critical to U.S. international competitiveness, especially in the area of capital goods exports which provided the United States with a surplus of $46 billion in our 1981 trade balance.

Some of the "zigs and zags" of U.S. foreign policy controls for various export transactions are documented in Table 1. The major long-term cost of these "zigs and zags" is the harm done to the credibility of U.S. manufacturers as reliable suppliers and business partners. This is especially true for high technology firms whose products supposedly provide the greatest leverage in our control policies. For example, an executive of one major semi-conductor firm stated in an NAM meeting on the recent U.S. pipeline controls that his company was worried that these controls established a precedent on technology transfers which jeopardized his industry's cross licensing agreements throughout the world.

TABLE I: EXAMPLES OF U.S. TRADE BEING TURNED "ON AND OFF" UNDER U.S. EXPORT CONTROL LAWS

DRESSER DRILL-BIT PLANT SALE TO U.S.S.R	SATELLITE COMMUNICATIONS SALE TO ARAB COUNTRIES (ARABSAT)	CATERPILLAR PIPELINE SALE TO U.S.S.R.	LOCKHEED L-1011 SALE TO IRAQ	ARMCO STEEL PLANT SALE TO U.S.S.R.
Aug. 9, 1978: The Department of Commerce approves license for Dresser to build $150 million drill-bit plant in USSR.	Oct. 30, 1981: State Department, as required in the Arms Export Control Act, notifies Congress of sale of satellite equipment to Arabsat.	July 1981: Reagan administration approves license to sell 100 pipelayers to the USSR.	April 6, 1982: Lockheed applies to export six L-1011s to Iraq.	1976-1979: Armco and Nippon Steel (Japan) work together to obtain a contract from the USSR for sale of equipment for a Soviet electrical steel plant.
Aug. 25, 1978: A special panel of administration officials reviews this transaction.	Nov. 4, 1981: U.S. license rescinded following Congressional criticism	Sept. 1981: Caterpillar applies for license to ship an additional 200 pipelayers to the Soviet Union for non-Yamal pipeline projects.	April 14, 1982: Administration approves license for sale of these planes to Iraqi Airways, a transaction worth $130 million.	Early December, 1979: Export licenses for Armco are approved.
Aug. 30, 1978: President Carter's senior advisers vote by a 3-to-2 margin to halt the transaction.	February 1982: Proposed sale notification resubmitted with non-recognition of PLO and other assurances made.	Dec. 8, 1981: Reagan administration approves license.	April 29, 1982: Letters opposing the sale are sent to President Reagan by the House and Senate.	Dec. 17, 1979: Contract is signed between the U.S., Japan and USSR.
Sept. 6, 1978: The President decides to allow the sale.		Dec. 29, 1981: As export license had not been formally issued by Commerce Department, export controls on oil and pipeline equipment to the USSR imposed by Reagan in response to Polish situation leads to suspension of license's issuance	April 30, 1982: Administration delays issuance of license.	Jan. 11, 1980: Armco's license is suspended as a result of Afghanistan-related sanctions against the USSR.
Jan. 4, 1980: As a result of oil and gas pipeline controls invoked in connection with Soviet invasion of Afghanistan, Dresser's license is revoked		Nov. 13, 1982: With lifting of December & June 1982 pipeline-related sanctions, Caterpillar's license is to be reviewed again.	May 25, 1982: License is issued.	April, 1980: The USSR terminates the contract, and Nippon Steel and Crevsot Loire of France undertake joint project with the USSR.
			September 1982: License is modified and approved.	

SOURCE: International Trade Reporter's U.S. Export Weekly, The Bureau of National Affairs Inc., Washington, D.C.

The question being raised here was whether direct products of U.S. technology exported under a general license are subject to future changes in U.S. foreign policy controls. The pipeline regulations issued in June 1982 certainly seemed to indicate this to be the case. These regulations appeared to apply to the transfer of technical data involving the production of oil and gas equipment regardless of when the transfer was made or whether it was subject to any explicit control regulations beyond a general export license.

It is clear that the terms of an export administration regulation applied at the time of a particular transaction subjects the foreign buyer to the conditions of the regulations, theoretically in perpetuity. It is open to question, however, if there exists adequate statutory basis for claiming that the control regulations in effect at the time of the transaction imply continued U.S. jurisdiction allowing for imposition of new controls at a later date which go beyond the terms of the original contract.

It is doubtful, moreover, that many foreign firms want to consider themselves, or will be allowed by their governments to become, prospective instruments of U.S. foreign policy simply because technical data they use is exported from the United States under a general license. Any jurisdictional claim by the United States along these lines places a significant burden on U.S. international commercial transactions involving licenses or other agreements for the transfer of U.S. technology.

IMPACT OF CONTROLS ON FOREIGN SUBSIDIARIES OF U.S. FIRMS

In addition to raising questions about the reliability of U.S. manufacturers, foreign policy controls when applied extraterritorially also affect the ability of foreign subsidiaries of U.S. firms to operate in accordance with the laws and policies of the nations in which they are incorporated. Ultimately, this has to affect the value of these foreign subsidiaries to the U.S. parent.

The U.S. government through the Export Administration Act asserts certain extraterritorial powers to control foreign subsidiaries of U.S. firms. Presidential authority in this instance derives from an amendment to the Export Administration Act which was included in the 1977 International Emergency Economic Powers Act. The language contained in the amendment is very broad, providing "authority for control over exports of non-origin U.S. goods and technology by foreign subsidiaries of U.S. concerns."

The legislative history of this amendment reveals more than a little confusion over what powers members of Congress thought they were granting the President. The principal House sponsor of the amendment stated that it was intended to ensure that the President had authority to maintain existing controls on foreign subsidiaries of U.S. companies. In 1977, such controls were limited to exports of embargoed nations and exports of strategic goods to Communist nations.

The Senate Banking Committee in passing the 1979 Export Administration Act considered this matter and decided not to take any action to limit Presidential power "pending further study of the issue." The Committee noted that the possible application of U.S. foreign policy controls to foreign subsidiaries of U.S. companies in "non-emergency situations may not have been considered adequately by the Congress at the time the provision was adopted."

As a practical matter, U.S. authority in this area is limited by the degree to which other governments will tolerate U.S. foreign policy controls on companies operating within their national boundaries. This was a lesson that we should have learned in the 1965 Fruehauf case when the U.S. Government directed the Fruehauf Company not to allow its French subsidiary to proceed with a sale of truck bodies to China. The impasse over this extraterritorial extension of U.S. control policy was broken only after the French courts placed the Fruehauf subsidiary in receivership. China got the truck bodies.

Other major industrial nations have aquiesced—with more than a little reluctance—to the extraterritorial nature of U.S. reexport for national security reasons. Their own export control laws after all are based on national security criteria. But the United States is the only country with an extensive set of foreign policy controls. If the recent pipeline controversy demonstrated nothing else, it showed that the Europeans were not going to acquiesce to the extraterritorial extension of U.S. foreign policy controls. The efforts by each side to press its claims to the fullest in the pipeline dispute obviously left the foreign subsidiaries of U.S. firms in an impossible situation—caught between competing national laws and regulations. This hardly represents a prescription for enhancing the international competitiveness of U.S. manufacturers.

BOOST TO FOREIGN COMPETITION

The repercussions of U.S. foreign policy controls is especially disturbing in light of the foreign availability of so many of the products covered by U.S. control regulations in this area. Market positions are established by U.S. manufacturers often with great difficulty and expense. Foreign competitors are reluctant to take on U.S. companies with established market positions because of the initial startup costs and time involved with such a challenge. When the U.S. Government unilaterally takes U.S. companies out of any particular market, foreign competitors quickly fill the vacuum with their products while ours are denied.

There seems to exist a particular temptation to impose controls unilaterally when U.S. industry has a competitive advantage in a market or product. The use of controls in such instances provides foreign competitors with "captured" markets which they can use to build up economies of scale and test new technology. This is what happened with respect to foreign competition in large diameter pipes, submersible pumps, and U.S. drilling bits; it is what is likely to happen with large scale turbines and other oil and gas equipment and technology.

The basic point that must be realized here is that foreign competitors of U.S. firms operate under a very different set of control policies than U.S. manufacturers. This point is extremely well illustrated in a new report done by an Ad Hoc Working Committee on Export Controls of the President's Export Council (copy attached). Among the findings of this Ad Hoc Working Committee were the following:

(1) U.S. attempts to achieve foreign policy objectives with exports controls. Other countries do not.

(2) Japan, France and the United Kingdom do not require export licenses for many countries. Canada is the only country so treated by the United States.

(3) U.S. controls technical data to free world destinations. Only Japan and Germany do anything similar, and then only for truly strategic commodities.

(4) Only the United States asserts sweeping extraterritoriality in its regulations. Others have nothing comparable.

(5) Only the United States has a denial list.

(6) Absent a declared national emergency, only the U.S. has applied controls retroactively, impacting contractual commitments.

The preceding differences, as well as others cited in the report, add up to a significant disincentive for U.S. manufacturers trying to compete in international markets.

1983 REAUTHORIZATION OF EXPORT ADMINISTRATION ACT

In light of the commercial impact of U.S. foreign policy controls which have been outlined above, there exists a strong interest within the manufacturing community to see Congress modify U.S. control policies, especially in the foreign policy area, when it reauthorizes the Export Administration Act (EAA) in 1983.

The last time the EAA was reauthorized was in 1979 when several major changes were made governing the use of controls for foreign policy reasons. The provisions pertaining to foreign policy controls were separated from those pertaining to national security. Specific criteria were established which the President was supposed to consider when imposing new controls. A consultation process between the Executive Branch, Congress, and industry on new control policies was spelled out. An annual "sunset" provision for all foreign policy controls was added to the Act. At the time they were enacted, these modifications in the EAA were seen as major steps toward rationalizing U.S. control policies.

Events since 1979 have demonstrated that the preceding modifications in the EAA were mainly hortatory and have had very little real impact on the actual operation of U.S. export controls. The criteria set forth on the use of foreign policy controls were not binding upon the President. The consultation process was largely perfunctory. The "sunset" provision led to only a few foreign policy controls actually being lifted. In short, even with the changes made in 1979, the EAA remains a broad, untested area of Presidential power.

There have been a number of possible options "floated" on ways in which U.S. foreign policy controls might be changed. These include:

1. Tighter drafting of the foreign policy provisions (Section 6) of the Export Administration Act.
2. Compensation for lost business due to export controls.
3. Changing the decisionmaking process for implementation of controls.
4. Congressional veto of new controls.
5. Congressional approval of new foreign policy controls.
6. Import controls for foreign policy reasons.

More detailed discussion of each of these options can be found in an attached memorandum prepared for a meeting of NAM's International Trade Policy Committee. It should be carefully noted here that not all of the preceding options are supported by NAM members and that in some instances there exists a good deal of opposition to some of the ideas listed above. But the preceding list and attached memorandum do provide an overview of the type of modifications in the U.S. control laws that are being discussed by various experts within the private sector.

SHULTZ BACKS DRESSER, VILIFIES EMBARGOES

(By George P. Shultz)

An extra element has been injected into international trade in the past few years, a political dimension overlaid on top of commercial transactions. This political element is a vigorous and flamboyantly administered initiative that uses foreign trade as a tactical instrument of foreign policy. I call it light-switch diplomacy.

There is apparently a belief in our government that individual trades can be turned on and off like a light switch to induce changes in the domestic and foreign policies of a host government. As a result, the position of U.S. goods in world markets is eroding as our trading partners increasingly see evidence that we cannot be counted on as a reliable supplier. The impression abroad now is, unfortunately, that the U.S. want foreign business on our own terms and that as yet we have not figured out what those terms are.

Examples of light-switch diplomacy abound. Take this chronology involving Dresser Industries $150 million contract to build a drill-bit plant in the Soviet Union. As a way of demonstrating our protest to Soviet treatment of dissidents, various presidential advisers urged the president [Jimmy Carter] to veto the sale.

Aug. 9 [1978]: The Commerce Dept. (reportedly with the president's blessing) approves Dresser's export license, enabling the company to go ahead with the sale.

Aug. 25: A special review panel convened at the request of the Defense Secretary advises against the "technology transfer."

Aug. 30: The president's senior advisers vote by a 3-to-2 margin to stop the deal.

Sept. 6: The president reaffirms the decision to allow the sale.

The light goes on, the light goes off, the light flickers, the light goes on. I don't know whether it is going to stay on or not but in the meanwhile it is hard to see that these manipulations have had any impact on the nature and operation of Soviet society.

Against this background, we must realize that our dependence on world trade has increased sharply. Exports and imports, considered together, are equivalent to about one-fifth of our gross national product, which is double what they represented a decade ago. Yet our share of world exports has been steadily declining. Our market share of exports of manufactured goods, for instance, has fallen almost 30 percent since the late 1950s.

Meanwhile, our appetite for imports has been voracious. These imports are not just a matter of taste and convenience. We can't just say, "Well, she doesn't need to have a handkerchief from Paris." We have come to depend on many of these imports to provide us with key commodities; oil is only the best-known example.

We must recognize that major commercial relationships cannot be turned on and off like a light switch; they have to be built up and sustained over a period of time. It takes a long time to go abroad, get positioned, and learn about how to do things there. A considerable investment is made on both sides of the transaction, and there emerges a certain interdependence that necessitates confidence in the continuing good faith of both sides. In this process of investment, a company develops what the government may regard as a bargaining chip. But if our government then takes that bargaining chip and spends it where does that leave the company? The company has lost out, and its commercial relationship deteriorates. Who wants to deal with an unreliable supplier, especially when the supplier is not the only game in town?

We can predict, even observe, that light-switch diplomacy as it is used more and more becomes a wasting asset. Increasingly, when the diplomat flicks the switch, the light will not go on. It will not go on because private firms cannot afford the cost, cannot make the investments, to create the bargaining chips and then have the bargaining chips used. And self-respecting trading partners will not put up with it.

If light-switch diplomacy is turning off our trading partners, what then is the proper relationship between trade and government policy?

(1) Governments should provide a stable and predictable set of rules under which trade can take place on individual and corporate initiatives, as free as possible from

the uncertainties inherent in the ad hoc exercise of government authority. Rules instead of authorities—rules that we can read; rules that are predictable.

(2) Traders, individual or corporate or government, must keep their bargains, and government must not place private parties in the position of breaking a bargain properly arrived at.

Certain products and countries may require special treatment on grounds of national security. But here, as elsewhere, rules are essential. If there is some product we should not sell, it should be specified. Just because a product is in an area linked to security does not mean we should just leave the whole thing open to the discretion of an ever-changing cast of characters who have access to the light switch. Ad hoc and changeable decisions add up to chaos and an environment that frustrates fruitful commercial relationships.

Outside the security-related area, rules should be kept to a minimum, be clear and consistent, and be as free as possible from the need for interpretation by government authorities.

If our government adheres to these principles, then U.S. companies can develop and uphold their reputation as reliable suppliers, a reputation essential to their success in export markets. When our government turns away from these principles, it correspondingly undermines our competitive position abroad.

PRESIDENT'S EXPORT COUNCIL; SUBCOMMITTEE ON EXPORT ADMINISTRATION; AD HOC WORKING COMMITTEE ON FOREIGN EXPORT CONTROLS—FINAL REPORT

The subject committee was appointed by David C. Scott, chairman of the President's Export Council Subcommittee on Export Administration, in late January of this year for the purpose of identifying differences in export regulation or practice between the United States and nine other exporting countries, differences which put U.S. exporters at a competitive disadvantage. The Commerce Department had requested such a study in order to know better where harmonization of export rules or practice should be sought.

The PEC Subcommittee members appointed to this working committee were: E. G. Law, IBM—Chairman; G. K. Bardos, CDC; J. A. Dukowitz, Texas Instruments; A. H. Hausman, Ampex; and T. L. Slater, ITT.

The nine countries chosen for comparison were six COCOM members (Canada, France, Germany, Italy, Japan, and the United Kingdom) and three non-COCOM countries with extensive East/West trade. (Austria, Switzerland, and Sweden). The primary interest on the part of both the Commerce and State Departments was in differences relating to treatment of East/West trade.

The ad hoc committee decided that it could also identify differences in West/West rules and practice without too much additional work, and that doing so would have value. As it turned out, some of the more significant differences are West/West rather than East/West. Even though harmonization on West/West treatment may be more difficult and hence longer term, we feel it is even more important quantitatively to U.S. export performance.

One of the first things the committee did was to obtain current Export Regulations from each of the nine countries. Copies were turned over to a USG interagency group which proceeded to analyze them for differences in the various countries covered. It is assumed that the group's conclusions are already figuring in current COCOM negotiations.

The ad hoc committee then proceeded to work out two questionnaires, the first of which was regulations specific while the second was commodity (product) specific. Sample pages of each are attached. We sought to obtain a foreign practitioner's perception of his country's regulations with the first and a measure of actual practice with the second. These were sent to the people responsible for export licensing in the foreign subsidiaries of the five companies represented on the working committee. Not all of the five companies had operating subsidiaries in each of the nine countries being surveyed, but our coverage was still quite good with at least two and often three responses per country.

The replies were tallied:

(1) In narrative form as received in the regulations specific case showing all answers received; and

(2) In spreadsheet form for the commodity specific questionnaire.

Summarization was also attempted across the nine countries in both cases. The compiled results are quite voluminous, and as a result will not be included in this report. However, complete copies have been furnished to both Commerce and State. Anyone else desiring to examine a copy can do so by contacting the ad hoc committee chairman. The raw country responses, which are even more voluminous, are also available for examination by anyone interested in pursuing the detail of any specific questions after reviewing the compiled results.

In the interest of brevity, this final report will be limited to conclusions drawn from the compiled results, followed by recommendations on subject areas needing harmonization.

East/West control

On exports to controlled countries (the non-market economies often referred to as the East Bloc) by COCOM member countries, a semblance of consistency is provided by the functioning of COCOM with its agreed upon "list", "notes", and regular reviews. COCOM country responses indicated a general conformance to what is understood as COCOM "rules". However, there are some important differences which emerged in the results.

(1) There is varying interpretation of the list and the notes and their application to specific "borderline" products by the different countries.

(2) Where the United States has numerous unilateral controls over and above the COCOM list, the other countries do not go beyond what is specifically required by COCOM agreement. This difference is very significant for certain product areas.

(3) There is a clear difference in elapsed time taken for approval of even cases which must go to COCOM review. While there is an even greater difference on cases which are not reviewed in COCOM, it is still worthy of note that COCOM cases are apparently brought to review more quickly by the other countries.

(4) There also appears to be an attitudinal difference. If COCOM "rules" do not specifically forbid an export, the other countries support and encourage it, whereas the United States often uses a variety of means to discourage an exporter unless the rules specifically permit the export in question. Foremost among these means is delay. Denial by long delay is much too common an occurrence. This may not be intentional. But it is often the result nevertheless. The survey would indicate that exporters in the other countries do not face the same problem.

(5) Technical data controls are far from being harmonized between COCOM members, in spite of some movement in the past two years. Perception of actual practice as well as the foreign regulations clearly indicate that U.S. high technology exporters suffer a significant competitive disadvantage regarding technical data. In some countries there is still no control, while in others it is significantly weaker than in the United States.

(6) National security is the only statutory basis for control in the majority of COCOM countries covered by our study. While a nod is given to foreign policy as possible justification in two instances, it was reported that this reason is almost never used. The United States, on the other hand, has used it quite frequently in the last two administrations.

Exports to controlled countries by the three non-COCOM countries (Austria, Sweden, and Switzerland) in our survey are, by comparison, practically uncontrolled. Austria has no comparable controls. Sweden controls only munitions items, and has only very recently undertaken to control reexport of very large U.S. computers to East bloc destinations. Switzerland has had a longer standing control on reexports without agreement of the original source country. Notwithstanding these reexport controls, the result is a significant competitive disadvantage for U.S. exporters wherever these three countries have their product capability.

West/West controls

As reported earlier, the difference in export controls for Western country destination is even more marked. The absence of anything resembling the COCOM framework for East bloc destinations has left each country free to control as little as it wants consistent with a view of its own national interest. Since all of the countries in our survey have long regarded export performance as something to be encouraged and supported in every possible way, it is no surprise that they have kept controls to a minimum. Successive U.S. Administrations have gone the other direction with more and more control.

Some examples of the resulting difference are:

(1) United States attempts to achieve foreign policy objectives with export controls. Other countries do not.

(2) United States has many exclusions to its bulk (special) licenses. Others do not. Hence much higher use of individual licenses required in United States.

(3) Japan, France, and the United Kingdom do not require export licenses for many countries. Canada is the only country so treated by the United States.

(4) United States uses national security reasons to deny licenses to free world destinations. Others do not.

(5) United States controls technical data to free world destinations. Only Japan and Germany do anything similar, and then only for truly strategic commodities.

(6) Only the United States asserts sweeping extraterritoriality of its regulations. Others have nothing comparable and do not attempt to control reexport of their products once outside their own borders with one minor German exception.

(7) Only the United States has a denial list.

(8) Only the United States and France have anti-boycott provisions, and the French ones are much more limited in scope.

(9) Only the United States requires exporters to obtain assurance against certain end uses. Many of the countries surveyed do not even require end use information on the license application.

(10) The time required to obtain U.S. license approval is clearly longer, even for the most favorable destinations.

(11) Absent a declared national emergency, only the United States has applied controls retroactively, impacting contractual commitments.

The above differences add up to a very significant competitive disadvantage for U.S. exporters. The various items have their effect in different ways, but each acts to limit U.S. export performance below what it could otherwise be. That export earnings and jobs are increasingly important to the U.S. economy seems generally agreed upon among informed Americans today, but what is still missing is a broader realization that the above differences between the United States and our export competitors contribute significantly to the problem.

RECOMMENDATIONS

East/West

Differences in COCOM country treatment of exports to the controlled countries are under negotiation no in COCOM. One of the objectives of the U.S. negotiating team is harmonization of differences. It is not as clear that this objective is fully shared by the other negotiators since some of the countries realize an export advantage from the differences. Absent a truly unique U.S. product capability, unilateral U.S. controls or tougher U.S. licensing criteria act simply to divert export business to our foreign competitors. Foreign availability is being given somewhat more attention, but it remains to be seen how well the information will be used when available. In most instances foreign competition is supplying comparable capability, even in high technology areas. Therefore, the committee recommends:

(1) That U.S. export control regulation and practice recognize that unilateral controls do not, with very rare exception, deprive the potential adversary of anything, but instead only act to harm U.S. export performance. The burden of proof to establish the effectiveness of a unilateral control should be on the control authorities.

(2) The effort to achieve harmonization of controls should be grounded on the understanding that the United States will not go beyond what is agreed upon in COCOM except in truly exceptional instances where a compelling, overriding reason can be stated.

(3) Harmonization must result in definitions which allow absolutely minimum room for interpretation. A continuing mechanism should be agreed upon for resolving differences in interpretation as soon as they develop.

(4) The opportunity to kill a U.S. export application by sitting on it indefinitely should be significantly narrowed by further tightening of review deadlines.

(5) The attitudinal difference mentioned in the conclusions above should be altered. U.S. export performance should be acknowledged by all concerned with the control process as being the most important consideration lacking some compelling contrary reason which can be clearly stated to the applicant.

(6) Recognizing that slower processing of export applications results from both the resource devoted and the complexity of the controls imposed, it should be acknowledged that if controls are not to be simplified or narrowed, then more resource has to be devoted to administering them. It is certainly poor economy to impact U.S. export sales, in which U.S. industry has already made a significant investment, by processing applications so much more slowly than our foreign competition does.

West/West

To the committee's knowledge, there is no present intention within Commerce, State, or Defense to alter U.S. West/West controls in any way that would bring them more into line with the simpler controls exercised over U.S. industry's foreign competition. On the contrary, there are changes under consideration that would go in the other direction toward greater differences, at least in high technology areas, where incidentally, the United States still has some competitiveness. It should be clearly recognized that such action will have even greater impact upon U.S. export performance.

In spite of that possibility, the committee recommends that a joint industry-government effort be mounted to examine the cost versus the benefit of each of the differences identified. The committee assumes the government can identify the presumed benefit to the United States of each of the differences. On the other hand, we suspect that the cost of each has not been as well identified, let alone quantified. We suggest that such an analysis would show that the benefit is not worth the cost to the U.S. export performance, at least on some of the differences.

That such an effort would be worthwhile presumes a sincere belief of all concerned that improvement in U.S. export performance is genuinely important, if not critical, to our economy. If that is lacking, particularly among government participants, there is probably no point to such a study.

REVIEW OF OPTIONS FOR MODIFYING FOREIGN POLICY CONTROLS ON U.S. EXPORTS

BACKGROUND

The Congress must act by September 30, 1983 to reauthorize the Export Administration Act (EAA). The reauthorization of this Act next year provides an obvious opportunity for modification of U.S export control law, especially in the area of foreign policy controls. This paper reviews some of the options which the NAM might choose to support in an effort to make our export control policy less of a burden on U.S. international business.

The last time the EAA was reauthorized was in 1979 when several major changes were made governing the use of controls for foreign policy reasons. The provisions pertaining to foreign policy controls were separated from those pertaining to national security. Specific criteria were established which the President was supposed to consider in imposing new controls. A consultation process between the Executive Branch, Congress, and industry on new control policies was spelled out. An annual "sunset" provision for all foreign policy controls was added to the Act. At the time they were enacted, these modifications in the EAA were seen as major steps toward rationalizing U.S. control policies.

Events since 1979 have demonstrated that the preceding modifications in the EAA were mainly hortatory and have had very little real impact on the actual operation of U.S. export controls. The criteria set forth on the use of foreign policy controls were not binding upon the President. The consultation process was largely perfunctory. The "sunset" provision led to only a few foreign policy controls actually being lifted. In short, even with the changes made in 1979, the EAA remains a broad, untested area of Presidential power—a fact most recently demonstrated by the U.S. control policies on oil and gas equipment exports to the Soviet Union.

OIL-GAS CONTROLS

The current U.S. controls on oil and gas equipment exports to the Soviet Union date back to 1978. In that year, the Carter Administration imposed validated license requirements on the export of oil and gas equipment and technology. A control mechanism, therefore, was put in place as a sign of U.S. displeasure, but no license applications were in fact denied at the time.

In early 1980, following the Soviet invasion of Afghanistan, the Carter Administration froze all exports of oil and gas equipment and high technology products to the Soviet Union. This policy was modified later in 1980 so that export licenses for oil and gas equipment generally were approved, while licenses for the export of technology were denied in most cases.

In December 1981, the Reagan Administration imposed further restrictions on the export of oil and gas equipment to the U.S.S.R. in response to Soviet Union's "heavy and direct responsibility" for the imposition of martial law in Poland. Several steps were taken at this time, including (1) suspension of all license applications for oil and gas equipment exports to the Soviet Union, (2) expansion of U.S. controls to include energy refining and transmission equipment, and (3) revision of the rules governing the export of certain technical data.

In June 1982, the Administration tightened U.S. control policies in this area even further by extending them not only to foreign subsidiaries of U.S. companies but also to goods produced by foreign companies using U.S. technology. The controls, despite some initial confusion in the Commerce Department regulations, were limited to oil and gas equipment.

Several basic questions have been raised by the control policies outlined above:

(1) The controls imposed in December 1981 raise the issue of the extent to which the EAA permits ex post application of new controls to completed export transactions that have taken place under a different set of control policies. The December controls, for example, assert jurisdiction over products purchased by European companies in the late 1970's under a general license. Real questions have been raised as to the extent to which not only the EAA but also provisions in various export contracts between United States and European firms permit such jurisdictional assertions.

(2) The controls promulgated in June 1982 bring up an additional question of the degree to which the EAA permits the extraterritorial application of U.S. foreign policy controls to foreign companies using U.S. technology in cases where no controls existed at the time of the original transfer of technical data. The June controls clearly attempt to assert control over technology transfers in the oil and gas equipment field regardless of when or how the transfer took place.

The debate over the preceding questions has produced an increasingly tangled legal web of points and counterpoints between the United States Government, European Governments, and the American business community. The United States Government, for example, asserts that the language in various contracts between United States and European firms gives the U.S. jurisdiction over goods produced under these contracts. Countering this assertion, many experts in this field have pointed out that the latest control policies catch up foreign products produced under contracts which have no provisions concerning U.S. export control policies. Furthermore, many contracts with such provisions also apparently have force majeur clauses which specify that assertions of sovereignty by a foreign firm's home government prevents the extraterritorial application of unilateral U.S. export restrictions.

EAA REAUTHORIZATION IN 1983

The most basic fact emerging from the latest embroilment over the EAA is that neither the substance of the law nor the procedures for implementing it are conducive to clear, consistent export control policies under which a U.S. manufacturer can assure reliable and continuing fulfillment of a long term contract. The reauthorization of the EAA in 1983 provides an opportunity for the NAM—and the business community as a whole—to address some of the problems of the Act and to seek changes that help reduce the uncertainty currently surrounding U.S. export control policies for foreign policy reasons. Some of the options that might be considered in this connection are discussed below:

(1) Tighter drafting of foreign policy control provisions in EAA.—Perhaps the most obvious approach available to reform of the EAA would be to redraft Section 6 of the Act (the foreign policy control section) to place greater restriction on the use of foreign policy controls, especially in non-emergency situations.

The Senate Banking Committee, for example, in 1979 considered an amendment to Section 6 which might have alleviated some of the difficulties over the extraterritorial reach of the latest U.S. control policies. The Committee took up an amendment to prohibit the imposition of new controls on exports of foreign subsidiaries of U.S. companies, except in international economic emergencies declared pursuant to the International Emergency Economic Powers Act. The amendment was withdrawn pending "further study of the issue."

Such an amendment would have brought the jurisdictional reach of the U.S. export control laws, at least for foreign policy reasons, into line with the jurisdictional scope of other U.S. laws such as the Foreign Corrupt Practices Act. Even the antiboycott provisions of the EAA apply to foreign subsidiaries of U.S. companies only when U.S. "interstate and foreign commerce" is involved.

In addition to clarifying the extraterritorial reach of the EAA, redrafting Section 6 might also attempt to clarify the ex post application of new U.S. controls to transactions either completed or entered into under a different set of control policies. Dresser Industries before the U.S. District Court raised this issue in regard to the June 1982 "pipeline" controls:

We do not contend that Dresser France cannot be directed by U.S. law not to make any new contracts to sell equipment for use on the Soviet-European pipeline. It is only the government's attempt to take away rights under a contract that already exists, in the face of superior interest of the French government, that brings these plaintiffs before the Court. And the retroactivity issue is presented here in the context of the underlying legal issue—Does the Act authorize such an attempt? For it is well settled that statutes will not be applied retroactively unless the statutory language makes manifest the intent of Congress to reach backwards.

Section 6 of the EAA could be redrafted to attempt to clarify the ability of the President to "reach backwards" and interrupt existing contracts in situations which do not involve national emergencies.

(2) Compensation for lost business due to export controls.—If Congress did not want to explicitly restrict Presidential powers under the EAA in the manner outlined above, it could require that U.S. companies be compensated for the business lost due to new control policies. Such compensation could be arranged either through (1) an amendment to the 1981 Overseas Private Investment Corporation Act which would permit OPIC to issue political risk insurance covering export restrictions or (2) an amendment to the EAA providing for direct compensation to manufacturers who have lost business because of new U.S. foreign policy controls.

Precedents already exist for this type of compensation policy in the agricultural sector. The most recent laws governing compensation for farmers in the event of an agricultural export embargo are contained in Section 1204 of the Agriculture and Food Act of 1981, which went into effect on December 22, 1981 (Public Law 97-98). Although the 1977 Act, the predecessor to the current bill, allows for payments to farmers when agricultural exports are reduced or curtailed due to domestic supply shortages, it was not until 1981 that agricultural embargo protection legislation was significantly expanded.

Under the current law, farmers are offered compensation when embargoes on agricultural commodities are undertaken by the government for national security or foreign policy reasons. Two conditions must be satisfied before any form of reimbursement is made available. First, the embargo must be selective—it cannot apply to all U.S. exports slated for one country or region. Secondly, in order to eliminate minor claims, U.S. export sales of the subject commodity to the targeted country had to have exceeded 3 percent of total U.S. export sales of that commodity during the preceding year. If these two conditions are met, compensation is offered to farmers either in the form of higher loans [100 percent of the parity price and/or special payments (according to formula outlined in Section 1204(b))].

Compensating U.S. manufacturers for lost business would not help to clear away existing uncertainties about the statutory limits of U.S. foreign policy controls. Such a policy could, however, affect the procedures under which decisions about control policies are made by forcing decisionmakers to address the immediate costs of their actions. In other words, a compensation policy for manufactured products similar to that of the agricultural sector might serve as a useful check on any tendency to reach for the export control "weapon" too quickly in reacting to international developments.

(3) Changing decisionmaking process.—There are other changes in the EAA beyond compensating companies for lost business that might be considered which would help check any tendency to reach for the export control "weapon" too quickly. Trying to affect the process in the Executive Branch by which a decision is made to impose foreign policy controls may be one of the more fruitful avenues to explore in the reauthorization of the EAA next year.

Areas for consideration in this regard might include the following:

The EAA could require that regulations in non-emergency situations be issued in proposed form and not go into effect until after a public comment period.

An advisory committee of technical experts might be established to review proposed regulations. Such a committee could report not only on technical problems associated with the proposed regulations but also evaluate the costs of the regulations.

The committee might report to both the Executive Branch and Congress. As noted above, the 1979 EAA clearly envisioned close consultations on the imposition of new foreign policy controls. The June 1982 controls illustrate the superficiality of the current process. An advisory committee, perhaps with specific reporting deadlines, might be a means of strengthening the consultation process envisioned in the 1979 EAA.

Improved administration procedures for reviewing the implementation of control regulations and sanctions could be revised in the reauthorization of the EAA. For example, the independence of the presiding officer in the current EAA appeals process might be increased and a more specific timetable for the administrative procedures could be required.

(4) *Congresssional veto of new controls.*—Another mechanism Congress might consider in restricting Presidential power under Section 6 of the EAA would be some form of Congressional veto of new controls.

Precedent for such a veto already exists in the EAA. If the President acts under Section 6 or Section 7 (short supply control section) of the Act "to prohibit or curtail any agricultural commodity", the Congress within thirty days can adopt a concurrent resolution disapproving the Presidential action and lifting the controls.

In 1979, the House version of the EAA would have permitted this type of Congressional disapproval of all new control policies whether applying to agricultural or industrial products. In the House-Senate Conference, this Congressional veto was limited to agriculture. But the Conference report stated that the conferees "agreed to give further consideration to a Congressional veto mechanism in subsequent legislation in the event that prior consultation [with the Executive Branch] on foreign policy controls proved inadequate under the provisions of this Act."

NAM support for this particular approach would be consistent with overall NAM policy on government regulations. This policy states that "Congress should be allowed the opportunity to prevent the adoption of rules or regulations that are inconsistent with Congressional intent, or that go beyond the legislation which the rules or regulations are designed to implement."

It should be noted, however, that Constitutional questions have been raised about the use of Congressional vetoes. Recent and pending decisions before the Supreme Court may have an important bearing on the feasibility of this approach to modifying U.S. export control laws next year.

(5) *Congressional approval of new foreign policy controls.*—Another approach to achieving greater Congressional involvement in the decision to use foreign policy controls would be to require specific Congressional approval for any new controls in this area. This approach would essentially entail the repeal of Presidential power under Section 6 of the EAA, at least in non-emergency situations.

Congress in the past has acted on specific export control issues—the most notable recent example involving U.S. controls on exports and imports from Uganda in 1978. At that time, over the objections of the Carter Administration, Congress imposed a mandatory ban on both imports and exports to Uganda. Detailed regulations, including a controversial extension of the controls to U.S. subsidiaries abroad, were proposed but never implemented because developments in Uganda eliminated the need for the U.S. embargo.

Proponents of this particular option for changing U.S. foreign policy controls cite a variety of arguments to support their case:

(a) The Constitutional issue of a Congress veto would be avoided;

(b) Congressional action to impose a new foreign policy control on U.S. exports, even under an expedited legislative procedure, would provide an opportunity to hear from all parties that would be affected by the controls;

(c) Controls enacted by Congress in concert with the President could prove more effective as expressions of a national purpose than controls imposed by the President alone.

Perhaps the major weakness of this approach would be the reluctance of Congress to tackle sensitive and difficult cases. There is no guarantee that Congress would be any less capricious in the application of control policies than the Executive Branch.

(6) *Import controls for foreign policy reasons.*—The President has greater power in nonemergency situations to restrict U.S. exports for foreign policy reasons than he has to restrict U.S. imports. In fact, the President has the power to "adjust" imports only when U.S. national security is directly involved. It is not surprising, therefore, that the burden of U.S. foreign policy controls fall almost exclusively on exports rather than on imports.

There may be very good reasons not to use import controls in various situations. But it is also illogical to have U.S. law weighted so heavily toward the use of export controls. For example, why should the United States have attempted in the late 1970's to cut off truck sales to Libya when it continued to buy Libyan oil which provided the Libyan government with foreign exchange to buy European trucks instead? The availability of import controls as a recognized and viable alternative to export controls might have led to a more rational U.S. policy in the case noted above and in similar situations in the future.

Moderator **Hardt**. Thank you very much.

We have been in effect looking at a kind of cost-benefit approach. We have been talking about whether or not we can use economic relations with the Soviet Union to our benefit. Dr. Simes has indicated yes, under certain conditions and yes, if you appreciate historical developments and we draw the appropriate lessons.

We are also looking at the costs, and some of the costs that have been very well illustrated for us are not only the direct costs which were more easily apparent to us, but also the indirect costs of the trading role of the United States in the world economy.

We also must keep in mind when we are dealing with our role in the world economy that we are in a recession period and we are in competition with other Western trading partners. So when we are talking about the political factors of unified policy we are also looking at a West-West competition. Market share and competitiveness, in terms of research and development effort and quality of product, as well as reliability and other considerations, are quite important.

So as we get our perspective in focus and we think in terms of a broader cost-benefit approach, these elements all have to be factored in.

Having Mr. Marcuss on this panel is a singular advantage in several regards, not only because of his rich academic background, his legal training and his work in private law practice, but also his experience here on the Hill. It is interesting that Mr. Simes mentioned the Stevenson amendment which is not a stranger to Mr. Marcuss who was counsel to the Senate Banking Committee at the time and worked directly with Senator Stevenson. His experience in the Department of Commerce as Acting Assistant Secretary of Commerce for International Trade at a time when some of the issues that have been discussed and that will be discussed were not only questions of history but were questions of immediate policy and moment. His interest has continued and recently he again attended the United States-U.S.S.R. Trade and Economic Council in Moscow, as he did in 1978.

So he has a varied background from the standpoint of private practice, academia, the Hill, the executive agency and brings to us a unique perspective to draw on in his testimony.

STATEMENT OF STANLEY J. MARCUSS, MILBANK, TWEED, HADLEY & McCLOY, FORMER SENIOR DEPUTY ASSISTANT SECRETARY FOR TRADE ADMINISTRATION, DEPARTMENT OF COMMERCE; COUNSEL, INTERNATIONAL FINANCE SUBCOMMITTEE, SENATE BANKING COMMITTEE AND SENATOR STEVENSON'S STAFF

LEGAL IMPLICATIONS OF U.S. TRADE ACTIONS

Mr. MARCUSS. Thank you, John.

It is fascinating, isn't it, how one can be involved in this field for so many years and continue to make the same mistakes year in and year out and see the same issues come around the corner year in and year out and see the difficulty people have in trying to find not only a resolution but even a clear articulation of what the issues are.

It seems to me, as I look back on almost 10 years of involvement in one form or another in these issues, to a much lesser extent to be sure than many other people at this table, I am struck how the issues recur, how the articulation remains essentially the same and how rhetoric seems principally to be the vehicle for communication of thoughts and ideas and how far away we seem to be still in understanding what it is that this is all about and what the options are, what the risks are and what the benefits are.

I thought I would summarize my paper which deals with an aspect of the issue on its face may seem to be fundamentally fairly dull, namely, the legal implications of the pipeline controversy.

I think in many ways the legal issues help to encapsulate a good deal of what I think is wrong with the way export controls are administered and, more importantly, I think are reflective of the failure to think through what it is that is intended by a particular course of action, a failure to think through what the implications of a particular course of action might be and I think also in many respects a failure to be honest with the American public and the world at large as to what it is that the administration, not only this one, but others, is doing when it exercises trade controls for foreign policy purposes.

I will read bits and pieces, but not the whole by any manner or means, of my paper.

I point out in my paper that the pipeline sanctions themselves were a very dramatic gesture and that they were intended, I think, to constitute a dramatic gesture of disapproval by the United States for a wide variety of Soviet actions. The pretext, as stated at least in the Federal Register notices and elsewhere, was the events in Poland. But we all know that, so far as oil and gas equipment and technology are concerned, the effort in this area goes back at least to August of 1978 when the United States imposed controls on exports of oil and gas equipment and technology to the Soviet Union for the first time.

At that time the immediate pretext was not energy but it was the Shcharansky and Ginsberg trials. Anyone who worked in this area knew that what the administration then was trying to do was to slow down Western involvement in Soviet energy development, and I think ever since then the Government has been inching more and more toward a policy of severely limiting Western involvement in overall Soviet economic development.

Clearly this is a policy with which Western Europe disagrees, and it was that disagreement that produced the eruption this summer when the administration decided it was time to impose sanctions on Western European firms that decided to go ahead with exporting equipment and technology for the Soviet natural gas pipeline despite the existence of the U.S. regulations.

Now, in my paper, I tried to point out how extraordinarily broad the sanctions were, and I think that is a very important point to reflect upon. It isn't principally a question of lawyers looking at lots of words and regulations and trying to spin out the most arcane theories of applicability, but it is a very real world problem with very real world consequences.

One at least has to ask the question of whether the administration, when it wrote the regulations and when it wrote the denial orders, consciously knew what it was doing and consciously attempted to cast the widest possible net or whether there was a degree of inadvertence.

As I point out, the definition of persons subject to the jurisdiction of the United States and, therefore, the array of persons and entities covered by the regulations is extremely broad. For example, the term "any person" wherever located who is a citizen or resident of the United States includes a U.S. citizen who is employed abroad by a foreign company. Any export to the Soviet Union that he might make for his company could have exposed him to penalties under U.S. law even if the goods were of wholly foreign origin and involved no U.S. origin technology.

That same U.S. citizen were he employed as an engineer, for example, by a British company in Britain could not have provided engineering services to help construct the pipeline without risking a violation of U.S. law, and it would not be necessary that he be a citizen. All he need be is a resident of the United States for the sanctions to have applied. Therefore, if he were, for example, the export manager of a German company and also happened to reside in the United States, he would have been subject to and indeed was subject to U.S. law and ran the risk of having penalties imposed upon him for any exports that he might make or facilitate to the Soviet Union for use in the pipeline or for that matter in any Soviet energy development, and so forth and so on.

As you will see if you read through this, some of the situations are absolutely bizarre. Wholly foreign companies, not subsidiaries of U.S. companies, became subject to the law if their chief executive officer was in the United States for a period of time. That is the way the regulations were written. So you could have the president of a Japanese company come to the United States, and, during the time that he was in the United States, his company in Japan was subject to U.S. law. If it were to have exported wholly Japanese goods and technology to the Soviet Union for energy production, exploration, transmission, or refining, that company would have been in violation of U.S. law.

Now you may say that is all bizarre and absurd. Well, it may be, and it probably is. The fact of the matter is that that is the way the regulations were written, and in the real world where banks have to decide whether a transaction is legal before they finance it, or the person who has to sign a contract has to decide whether it is legal before he puts his name to it, these are very real world problems with very real world consequences.

So as a consequence of these very broadly written regulations, there were literally hundreds of companies and thousands of transactions all around the world that were subject to U.S. law, and either consciously or unconsciously, deliberately or not, were affected and chilled in their overall business relations now and for the future with respect to the Soviet Union.

I point out in my paper, that while the controversy was generally described as a pipeline controversy, it was far more than a pipeline controversy. It had to do with the whole array of Soviet energy development. The U.S. sanctions were not limited to involvement with the pipeline, but they applied to any involvement in any Soviet energy exploration, production, transmission, or refining.

Now, as we know, enforcement of the regulations was an extremely formidable task. The United States could have imposed monetary fines against foreign companies. It could have sought to imprison individuals who were responsible for the actions of foreign companies. It did not—in my view wisely—but instead it chose to apply the more traditional penalty of blacklisting, and as we know, before the sanctions were lifted, a total of 12 European firms altogether were blacklisted.

Now blacklisting in and of itself is a fascinating exercise, particularly when one looks at the form of the denial order that was issued in standard form against each of these 12 companies.

I point out in my paper just one of many hypotheticals that illustrate how broad those denial orders were. For example, if a British bank, having no connection whatever with the United States, had financed a German company's export of trucks with U.S. origin tires to a subsidiary of Creusot Loire, which was blacklisted, to deliver heating oil to homes in Fez, Morocco, the British bank, the German company, and the French subsidiary all would have been in violation of the U.S. law.

Mr. JENKINS. And the U.S. tire manufacturer.

Mr. MARCUSS. And the U.S. tire manufacturer as well, as Jenks points out. [Laughter.]

Now it is just a little hard to see how that transaction, and there are many others that were similarly affected, would have much, if anything, to do with the Soviet Union and would have much, if anything, to do with U.S. foreign policy. Indeed the possibilities for sharply adverse consequences for U.S. policy in other parts of the world existed and were not recognized.

For example, there were a number of transactions that involved in some very limited way companies like John Brown or Creusot Loire or Nuovo Pignone with respect to refinery operations in China or elsewhere. We were asked to give an opinion on several occasions as to whether transactions such as those could go forward without violating U.S. law. Because they happened to involve goods produced abroad to some minor extent with U.S. origin technology and happened to involve companies that were subject to the denial orders, these transactions were not legal under U.S. regulations.

So we had to give opinions from time to time that U.S. companies were not legally free to go forward with transactions in China. I just wonder to what extent the administration deliberately thought about its foreign relations with China when it imposed sanctions against companies that had some connection with the Soviet Union.

It is easy and comforting in many ways to say that foreign policy controls don't work and that they shouldn't be used and that the American business community is unduly hampered through the exercise of foreign policy export controls. I think it is unrealistic to expect that in today's world where economic relationships are such an important part of overall foreign relationships that American companies will ever be totally free from the interplay of foreign policy and economic relations.

It does seem to me that at a minimum the business community and U.S. citizens as a whole are entitled to a degree of fair play, and by that I mean a degree of respect for contracts that have already been entered into, judicious limits on the extraterritorial reach of U.S. law and a degree of due process in the imposition of and the implementation of foreign policy export controls.

Today it is the United States that by and large seeks to impose its views of the world on an unreceptive audience, but I think the day is rapidly coming when other countries will quickly learn the lesson and seek to do the same themselves.

For example, it is interesting to speculate on how the United States would have felt if during the Falkland Islands crisis the British had attempted to prevent American companies that happened to be subsidiaries of British companies from trading with Argentina. I think we would have regarded that as a fairly fundamental interference with our foreign relations with Argentina, and yet that is precisely what we have attempted to do with respect to the Soviet Union and our allies' involvement in Soviet economic development.

Now where does all this lead? As in 1974, or in 1976, 1977, or 1979, I think it is very hard to say. The Export Administration Act which was the vehicle for the imposition of these controls and the imposition of these sanctions comes up for renewal again. Anyone who has been involved in past exercises with respect to the renewal of that statute and efforts to introduce a degree of rationality to its implementation will realize how difficult it is to accomplish much of anything by way of changes in the law. Nevertheless, it seems to me that some effort along those lines still might be productive despite the general disappointment with the consequences of the changes that were made in the law in 1979. Bob Russell, who is sitting in the front row there, had a great deal to do with those changes and was at the time counsel to the subcommittee of the Senate Banking Committee that had jurisdiction over that legislation.

I think we would be interested in your comments, Bob, but my general view is that despite an enormous amount of effort on the part of the business community, the administration and Members of Congress in 1979 to reform the Export Administration Act, it really hasn't amounted to very much.

In my paper, I list a number of things that seem to me at least to have some possibility for affecting behavior, affecting attitudes, affecting procedures and affecting rights—changes that could be made in the Export Administration Act. Just let me quickly tick them off.

No. 1, it seems to me to be fundamental that we look squarely at the question of extraterritorial reach so as to minimize conflicts with the law or policy of foreign jurisdictions. If one analyzes the extraterritorial issues carefully, I think one can fairly conclude that most of what the United States seeks to do by way of regulating the activities of foreign companies that happen to be licensees or subsidiaries of U.S. companies can be done through the exercise of territorial jurisdiction and not extraterritorial jurisdiction in a much more traditional fashion and in ways that are much more a consonant with establish precepts of international law.

The United States, after all, has jurisdiction over the parent company and in a traditional exercise of territorial jurisdiction—applying the territorial principal or the nationality principal—it probably can accomplish most of what it seeks to do without offending the sovereignty of other nations by the exercise of extraterritorial jurisdiction.

No. 2, similarly, it seems to me that in circumstances where there is a conflict, where the regulated entity finds itself in a situation of conflict between the laws and policies of its host country and the laws and policies of the United States, there should be built into the system a very strong bias in favor of resolving that conflict by permitting the party that is in a situation of conflict to obey the laws of its host country.

No. 3, it seems to me that we really ought to mandate advance consultation with foreign countries with which U.S. foreign policy—based assertions of extraterritorial jurisdiction conflict. We are seeing around the world a growing interest in the enactment of blocking statutes because of the exercise by the United States of extraterritorial jurisdiction. This has been a sore point with the Australians, with the Canadians and with the British for years, particularly in the areas of antitrust, and there is a growing recognition that we cannot continue to put ourselves in situations where we are in conflict with the policy of a foreign jurisdiction without in the long-term severely restricting our ability to achieve important national objectives. So I think mandatory advance consultation is an important principle.

No. 4, I think there is utility in mandating and enforcing a required report to Congress on criteria that are presently required by the Export Administration Act to be considered when foreign policy export controls are imposed.

The last time around in 1979 a great deal of effort went into identifying criteria that ought to be considered and that ought to be applied in the exercise of foreign policy export controls. In order to enforce that required exercise, Congress mandated that a report be made to Congress each time foreign policy controls are exercised.

The fact of the matter is that that requirement has been largely ignored. The report to the Congress on the pipeline sanctions which were imposed after all last June I am told was made just a few days ago, although I have not seen it. This mind you is after the controls were lifted. So I think enforcing the required report is important.

I would also recommend that the current statutory mandate to consult with affected industries prior to imposing controls be strengthened. The current mandate is largely ignored. I think if one were to do a survey of those companies that were affected by the pipeline sanctions, one would find that very few of them were consulted, and most were consulted at the 11th hour by virtue of a telephone call indicating that sanctions were about to be imposed, this is what they provide what do you think, thanks a lot and goodbye. If these things are going to be in the law and if they make some sense, and I think they do, they need to be enforced.

I would also recommend establishing a permanent technical advisory committee with which the executive branch would be required to consult in advance as to the practical and the technical aspects of any proposed controls. That may sound relatively insignificant, but I can't believe that the administration really did intend that the regulations that it issued last June and the denial orders that it issued against these various companies that allegedly violated the regulations apply to the kinds of situations that I was suggesting a little while ago.

It seems to me that if they had been required to sit down with the appropriate people to discuss what they proposed to do simply from a technical point of view, they might have learned a great deal about what it is that they in fact were accomplishing and how much of what they were doing was counterproductive.

No. 7, I would impose limits on the ability to interfere with existing contracts. There are very few circumstances, it seems to me, although there may be some, when for foreign policy reasons, not national security reasons but for foreign policy reasons there is adequate justification for interfering with existing contracts.

As Howard points out, the long-term consequences are extremely severe with respect to our ability to develop long-term meaningful trading relationships with other countries. When the buyer of U.S. technology in Japan is put on notice, as he has now been put on notice as a result of the pipeline sanctions, that at any time in the life of a 20-year technology licensing agreement the utility and the value of that licensing agreement can be terminated and destroyed, he necessarily has to think twice about entering into long-term contracts or any contracts for that matter with the United States. In areas of the world having nothing whatever to do with the Soviet Union that is bound to have a long-term adverse impact on our ability to achieve some of our economic objectives in those countries.

I would also limit the ability of the executive branch to issue so-called temporary denial orders for alleged violations of the law. As you know, the denial orders were issued against each of these 12 companies. They had the effect of permanent sanctions. There was no functional difference between the two. These denial orders with their sweeping breadth and their ability to terminate the ability of these companies to export goods from the United States and to import goods from the United States had very, very severe consequences. Yet, they could be imposed without notice. They could be imposed and were imposed without a hearing. They could be imposed and were imposed without the development of a factual record. The fact of the matter is there was no way to secure anything like a meaningful appeal.

Dresser went to court, and the court said go back to the Commerce Department. The only process available was a process whereby one had to go back to the hearing commissioner who issued the original order to make arguments before him that the order should not be issued. That is an exercise in total futility. The only appeal route available is to the Assistant Secretary, the very person involved presumably in the development of the policy in the first instance.

In short, there is no due process associated with the issuance of temporary denial orders, and I think that a denial order is a fairly extraordinary penalty to have imposed without the fundamental precepts of due process being respected.

Skipping over No. 9 because I really encompassed that in the last point, I would reform the aiding and abetting provisions of the Export Administration regulations. For those of you who have never looked at them, they are really quite an extraordinary piece of literature. I don't have my copy here at the moment, but the way those aiding and abetting regulations read, they make it a violation of the law for anyone anywhere in the world, even if that person or entity has absolutely no connection with the United States, to aid, abet, permit, allow, countenance, sanction, authorize or act with knowledge of a violation of U.S. export regulations or U.S. export sanctions.

Well, again, this all may sound very silly, but I can tell you that when banks look at multimillion dollar financings around the world, they typically go to their counsel and ask whether there is any legal infirmity in the proposed financing. No lawyer worth his salt who looks at the Export Administration regulations in the face of this sort of aiding and abetting language can give such a transaction a clean bill of health. There must be a caveat, and that has a significant chilling effect on all kinds of business relations.

No. 11, I would consider the establishment of an insurance system of some sort that would compensate companies that are affected by foreign policy export controls. It seems to me this is a relatively fundamental philosophical question. The question is who should bear the cost of U.S. foreign policy? Should the cost be borne idiosyncratically, if you will, on the basis of those who happen to be in the middle of a transaction or who happen to be developing proposed transactions at any point in time, or should it be borne by the population as a whole?

Finally, I would provide for judicial review of reforms that are made in the Export Administration Act. There is, as a practical matter, no real way to enforce any of these provisions, provisions, for example, having to do with a requirement that the executive branch consider certain criteria or that it file a report to Congress or that it meet certain deadlines. As a practical matter, there is no effective way to enforce those kinds of reforms unless one has access to the courts.

It seems to me, recognizing full well the traditional deference of the Judiciary to the executive branch in the foreign policy area, that there is nonetheless room from some kind of judicial review.

Well, these are some of the measures which could be taken. We are operating in the context of a very unhappy episode that has established a precedent with respect to the excercise of U.S. foreign policy controls and the exercise of U.S. extraterritorial jurisdiction. It seems to me that next year might be a very good time to confront some of these issues and to see if some solutions can't be devised.

[Mr. Marcuss' prepared statement follows:]

PREPARED STATEMENT OF STANLEY J. MARCUSS

The Soviet pipeline controversy is over—for the moment at least. But in its wake there lie the remains of numerous unresolved legal, commercial and foreign policy conflicts that will continue to haunt America's relations with the rest of the world unless a way is found to prevent their resurrection in the future. The expiration of the Export Administration Act next year and the need for its renewal present an opportunity to resolve issues of extraterritoriality, retroactivity and due process that the pipeline controversy did much to highlight.

BACKGROUND

In themselves, the Soviet pipeline sanctions constituted a dramatic and highly visible gesture of disapproval by the United States for a wide variety of Soviet actions and policies. The immediate pretext for the sanctions was the events in Poland. But going back to August of 1978—when it imposed controls on exports from the United States of oil and gas equipment to the Soviet Union for the first time—the U.S. Government has been inching more and more toward a policy that seeks to terminate or severely limit Western involvement in Soviet energy projects—as well as Soviet economic development generally.

This is a policy with which Western Europe largely disagrees. The disagreement is not only over energy policy, but over a wide array of other issues that go to the heart of the East-West relationship. That disagreement has been simmering for a long time. It finally erupted this summer when the Administration decided to punish a number of European firms that defied U.S. sanctions and went ahead with their Soviet pipeline contracts—sometimes under orders from their own governments and pursuant to contracts entered into a long time ago. Whatever lessons may be drawn from these events, it is clear that United States and foreign firms once again found themselves caught in the middle of a serious foreign policy disagreement.

BREADTH OF THE SANCTIONS

One of the little noticed aspects of the President's decision last June to expand the pipeline sanctions against the Soviet Union was their extraordinary breadth. As generally reported, the President's decision barred foreign licensees of U.S. technology from using that technology to produce components for the Trans-Siberian pipeline that will supply natural gas to Western Europe. As also generally reported, the President's decision also barred U.S. foreign subsidiaries from producing goods for the pipeline regardless of whether U.S.-origin technology or materials were involved.

As actually written, however, the regulations implementing the President's decision went much further. They covered a wide variety of entities, goods and services that had little, if any, connection with the United States and little, if any, connection with the Trans-Siberian pipeline. And they applied retroactively to contracts entered into many years ago. As a result, attempted enforcement of those sanctions entangled a wide variety of persons, entities and business relationships around the globe in the intricacies of U.S. export control law. It also raised serious legal issues relating to how far the United States can and should go in attempting to assert jurisdiction over foreign persons and entities. European disregard of the sanctions brought these issues to the fore.

PERSONS AND ENTITIES COVERED

The pipeline sanctions applied to "any person subject to the jurisdiction of the United States." As defined, that term included:

(i) Any person, wherever located, who is a citizen or resident of the United States;

(ii) Any person actually within the United States;

(iii) Any corporation organized under the laws of the United States; or

(iv) Any organization, wherever it is located, that is owned or controlled by any of the persons or entities I just mentioned.

Under this sweeping definition, a vast variety of individuals and entities in widely varying situations was swept into the net of U.S. law. For example, the term "any person, wherever located, who is a citizen or resident of the United States" includes a U.S. citizen who is employed abroad by a foreign company. Any export to the Soviet Union that he might make for his company could have exposed him to penalties under U.S. law even if the goods were of wholly foreign origin and involved no U.S.-origin technology. That same U.S. citizen, were he employed as an engineer, say, for a British company, could not have provided engineering services to help construct the pipeline without risking a violation of U.S. law. And it would not be necessary that he be a citizen of the United States; all he need be is a "resident" of the United States. Hence, the sanctions would have applied to the export manager or the vice president in charge of sales of a German company even though he was a German citizen if he also happened to be a resident of the United States.

Moreover, since the regulations also apply to "any person actually within the United States," the president or any other officer or employee of a Japanese, French or German company would have been covered—were he to have come to say, New York or Washington—during the period that he was actually in this country. Hence, if, while in the United States, he authorized an export from abroad of a wholly foreign origin product to be used in connection with the pipeline, he would have risked being penalized under U.S. law.

In addition, since the regulations applied to "any organization, owned or controlled by" any person subject to the regulations, they covered, for example, Japanese companies that had no connection whatever with the United States except for the fact that their president or chief executive officer happened to be "actually within the United States" on however brief a visit while the sanctions were in effect. While he was here, his company was subject to U.S. law and in potential violation of the regulations in its dealings with the Soviet Union.

And finally, since U.S. export regulations in general apply to anyone who assists anyone else in engaging in a transaction that is prohibited by U.S. law, they swept within their net banks, insurance companies, shippers, freight forwarders, accounting firms and perhaps even lawyers who assisted any of the persons or entities just mentioned in making exports to the Soviet Union. And it mattered not that the person or entity providing such assistance might be wholly foreign, since the aiding and abetting provisions of the regulations are not limited to "persons subject to the jurisdiction of the United States." They apply to anyone and everyone, United States or foreign. Hence a British bank that financed exports of pipeline parts produced in Britain under license from a U.S. company might itself have been in violation of U.S. law.

GOODS AND TECHNOLOGY COVERED

It is worth noting that, while the newspapers generally described the sanctions as applying to exports for the Trans-Siberian pipeline, the sanctions encompassed far more than the pipeline. One of the unofficially stated purposes of the sanctions was to halt or delay construction of the pipeline for fear that it would make Western Europe dangerously dependent on Soviet natural gas. But the sanctions applied to all equipment and technology relating to oil and gas exploration, production, refining and transmission anywhere in the Soviet Union. Hence, their application to U.S. foreign subsidiaries, licensees and other foreign companies was in reality an embargo on their participation in any Soviet petroleum energy development, not just participation in the pipeline.

Thus, while the newspapers reported a European outcry over the U.S. effort to block their participation in the pipeline, the sanctions were in fact an attempt to block their participation in all Soviet petroleum development. U.S. subsidiaries that had been manufacturing drilling rigs abroad or wholly foreign companies that had been manufacturing oil field equipment under U.S. license could no longer export that equipment to the Soviet Union without violating U.S. law. The regulations that replaced the pipeline sanctions still require U.S. approval for export to the Soviet Union of oil or gas exploration or production equipment produced abroad with technology exported from the United States. So even though the brouhaha over the pipeline has died down, this aspect of the current regulation could easily trigger new frictions with Europe and Japan in the future.

ENFORCEMENT OF THE REGULATIONS

Enforcement of the sanctions proved to be a formidable task. Leaving aside matters of definition, such as when is a foreign corporation "controlled" or "owned" by a U.S. person or a person physically present within the United States, one of the principal problems was undoubtedly in deciding how far to apply the traditional penalty of blacklisting.

Under U.S. law, each violation of the sanctions could bring substantial monetary fines. In addition, individuals could be imprisoned for up to ten years. The Administration could have sought to impose fines against foreign persons and entities that violated the regulations. It could have sought to imprison officers of offending foreign corporations had they happened to be in the United States. But because of the difficult issues associated with attempting to collect monetary penalties against foreign corporations and because of the fundamental legal challenges to the authority of U.S. law that would undoubtedly have been mounted had imprisonment been sought, blacklisting of offending foreign corporations was the only penalty that was realistically possible.

Before the sanctions were lifted, a total of twelve European firms had been blacklisted. Blacklisting had immediate widespread consequences. Blacklisted firms could not participate in any transaction involving U.S.-origin equipment or technology relating to oil or gas exploration, production, transmission or refining regardless of whether the transaction related to the Soviet Union or any other country in the world. In addition, no person, whether in the United States or abroad, could participate in any transaction with a blacklisted firm involving the transfer of U.S.-origin goods or technology relating to oil and gas, again, regardless of whether the transaction related to the Soviet Union or any other country.

Hence, the British subsidiary of a U.S. corporation could not legally fulfill existing petroleum equipment contracts with another British firm, or with any other firm that had violated the sanctions even if those contracts had absolutely nothing to do with exports to the Soviet Union. As a consequence, a wide variety of firms, whether European, American or otherwise, risked violating U.S. law—and would themselves have been subject to blacklisting—were they to have sold petroleum equipment or technology to blacklisted firms.

For example, if a British bank—having no connection with the United States—had financed a German company's export of trucks with U.S.-origin tires to a subsidiary of the French Company, Creusot Loire, in Morocco (Creusot Loire being one of the blacklisted companies) to deliver heating oil to homes in Fez, Morocco, the British bank, the German company and the French company could have been in violation of U.S. law. By the same token, if a U.S. company exported U.S.-origin sheet metal to John Brown in England, one of the blacklisted firms, for use in a refinery in China, the U.S. company, John Brown and the Chinese refining enterprise could have been in violation of U.S. law. Penalizing companies in these situations would have taken the Administration pretty far afield from its concern over Soviet energy development, but such penalties were a distinct possibility under U.S. law as it then stood.

It is not hard to see how the net, once cast, began to ensnare hundreds, if not thousands, of companies all around the globe. Supply chains in large projects tend to be long. Each company in the chain faced the risk of sanctions being imposed against it if it supplied U.S.-origin equipment or technology to a company in the chain that had been blacklisted. And as companies in the chain were blacklisted, all those who deal with them in turn faced the risk of being blacklisted themselves.

ENFORCING THE SANCTIONS

Faced with the prospect of tainting an ever-growing array of business relationships, the Administration decided to back off. Sanctions against the blacklisted companies did nothing to halt their participation in the Soviet pipeline. And to penalize those who dealt with blacklisted firms in petroleum-related transactions that had nothing to do with the Soviet Union, would undoubtedly have produced an irresistible outcry for moderation. Yet moderation, wise and necessary as it may be, itself is a political act and might be seen, by some at least, as a failure to stay the course.

Unfortunately there was no easy way out of the dilemmas that were created. The lesson is not that the Administration was necessarily wrong in being tough with the Soviets for their actions in Poland or that there are not legitimate concerns about European dependence on Soviet natural gas. Rather the lesson is that trade relations involve an intricate web of economic and political relationships that quickly start to unravel once some of the strings are severed. The adage that one should look before one leaps could be no more appropriate than in situations such as these. Without European cooperation, the pipeline sanctions were inflicting greater harm on the NATO alliance and on U.S. businesses than they ever could on the Soviet Union. And even though they have been lifted, they may inflict long-term harm on the American economy, for companies in Japan and Europe will think twice in the future about entering into transactions with U.S. firms knowing that they can be interrupted without notice and on a retroactive basis.

President Andrew Jackson once said of a decision by Supreme Court Justice Marshall, "he has made his decision, now let him enforce it." President Reagan made his decision; but the United States was unable effectively to enforce it.

LOOKING TO THE FUTURE

The business community cannot expect totally to avoid being caught in the crossfire of foreign policy disputes among nations. In today's world, economic relations are an inevitable part of foreign policy, and no company doing business internationally can expect to be immune from the foreign policy consequences of its activities. But at a minimum, the business community is entitled to expect a degree of fair play—respect for contracts entered into—judicious limits on the extraterritorial reach of a country's laws—and a recognition that a measured response is often far more effective than one that shoots first and asks questions afterwards.

Today, it is the United States that seeks to impose its views on an unreceptive audience on an important matter of economic and foreign policy. But others are beginning to catch on. There are today in Europe and elsewhere proposals that would subject U.S. companies to regulation by foreign countries just because they have subsidiaries abroad.

I doubt very much that we would appreciate it if U.S. companies were put in the position of having to decide whether to obey U.S. or foreign law were conflicts to arise. Yet that is precisely what we force foreign firms that were caught in the middle of the pipeline controversy to do. I doubt very much that we would have liked it if the British had ordered U.S. subsidiaries of British firms in the U.S to stop trading with Argentina during the Falkland crisis. Yet we were telling many European firms to stop doing business with the Soviet Union in the energy field because of strained United States-Soviet relations.

The United States is no longer the dominant economic power that it was after the end of the Second World War. As other centers of economic power continue to emerge, the United States will confront increasing disagreements—not just over the Soviet Union—but over fundamental social and economic issues. If the world is ever to develop a rule of law where nations reconcile their difference without resorting to force—physical or otherwise—a first step is to recognize that an accommodation to differences of view is an essential building block. If the United States hopes to generate that perspective in others, it must first demonstrate that it holds that perspective itself.

CHANGES IN THE EXPORT ADMINISTRATION ACT

A first step would be a series of amendments to the Export Administration Act when it is before Congress for renewal next year. Among the changes that should be considered are the following:

1. Limits on the extraterritorial reach of U.S. law so as to minimize conflicts with the law or policy of foreign jurisdictions.
2. Limits on the extraterritorial reach of U.S. law so as to avoid, where possible, situations where the person or entity to be regulated by U.S. law is subject to conflicting foreign law or regulation.
3. Mandatory advance consultation with foreign countries with which U.S. foreign policy-based assertions of extraterritorial jurisdiction conflict.
4. Mandate and enforce a required report to Congress on criteria presently required by the Export Administration Act to be considered when foreign policy export controls are imposed. (Note.—No report on the June 22nd pipeline sanctions was ever prepared and submitted to Congress as required by law.)
5. Strengthen current statutory mandate to consult with affected industries prior to imposing foreign policy export controls. (Note.—Current mandate is largely ignored.)
6. Establishment of a permanent technical advisory committee with which the executive branch would be required to consult in advance as to the practical and technical (but not policy) aspects of proposed foreign policy controls.
7. Limit the ability of the executive branch to interfere with existing contracts when imposing foreign policy export controls.
8. Limit the ability of the executive branch to issue "temporary denial orders" for alleged violations of export regulations since such "temporary" orders may be functionally indistinguishable from permanent denial orders.
9. Reform the administrative process within the Commerce Department so as to provide meaningful review of Departmental enforcement actions. (The current system mixes policy decisions with enforcement and fact-finding exercises, and, thus, denies basic precepts of procedural due process.)
10. Reform the "aiding and abetting" provisions of the Export Administration regulations and the corresponding provisions in denial orders so as to limit their scope to transactions that violate foreign policy export regulations. (Present provisions sweep a vast array of wholly unrelated entities and transactions into the net and, thus, penalize persons and entities whose transactions may be of no foreign policy concern whatever.)
11. Consider establishment of an insurance system that would compensate persons and entities whose transactions are adversely affected by foreign policy export controls.
12. Provide for early judicial review of foreign policy export control actions so as to provide a meaningful means of enforcing provisions of the Export Administration Act. (Present law leaves the executive branch with virtually unbridled discretion.)

These are but some of the measures that should be considered. They are by no means trouble free. But the unhappy episode of the pipeline sanctions should teach us that there is something woefully wrong with the current system and that reform is long overdue.

Moderator **HARDT**. Thank you very much, Stanley.

I would like to ask a few generalized questions to the panel before opening it for discussion among yourselves and then to the broader group.

One general question implied in the discussion relates to the pipeline sanctions and our present options, and it might be useful to explore what effect of the sanctions carries on, even though they have been removed. In other words, what impacts are we forced to live with from the sanctions even though they have been removed and what carry on as factors, perhaps plus or minus, affecting the effectiveness of our policy?

Second, there is the inference in our discussion that we are dealing not just with U.S. trade policy, but in dealing with the Soviet Union it is important to have a unified overall Western policy. It is also implied as well that we will inevitably have some foreign policy aspects in our trade relationships. The requirement therefore exists for having some kind of relationship between our Government trade and foreign policy considerations.

There is a third factor which is the question of the long term effect on our relations suggested by what Dimitri said in terms of the Soviet expectation for longer term relationships, longer term contracts, and what Howard said in terms of the importance of long-term contracts in normal U.S. business relationships, particularly in capital goods that may make these relationships of benefit to American industrial manufacturing businesses.

In each of these there seemed to be some dilemmas: If the administration has long-time relationships with the Soviet Union; if they try to use the element of trade for foreign policy purposes; and if they try to have a unified policy based upon consultation with business, with allies and with Congress, they have the problem of either effecting a policy change or foregoing the opportunity to develop a process that is based upon agreement and consultation? How do we continue a policy that is beneficial to us and effective on them, that is long term in nature and yet may be interrupted for "foreign policy" purposes? How do we deal with this problem in the context of our collective interests?

One specific point that Stanley mentioned in reference to insurance has very considerable budgetary implications. If we are to "make whole" businesses affected by the sanctions or other use of foreign policy criteria, we have a very substantial bill to be presented to the U.S. Government from time to time by the affected industries. So how do we square the continuing need for a unified policy, for a policy that is long-term in nature and still retain our flexibility in terms of use of foreign policy and impact on the Soviet Union?

Would any of you like to comment on that panoply of questions?

Mr. Marcuss. There is a premise in your question that I think needs to be examined, and that is the premise that we need flexibility of a sort that would impair a long-term policy, and I am not so sure that is true.

One is always fond of saying we need a long-term policy of course, and that somehow conveys a sort of magic notion that a long-term policy is a good thing and the absence of a long-term policy is a bad thing, and it conveys all sorts of overtones of stability and rational planning, and so forth.

Unfortunately, most long-term policies collapse the day they are born because the world changes much too rapidly. It seems to me that in a United States-Soviet trade context one has to identify the basic objectives to be achieved. I would just suggest one objective that needs to be thought about and in a sense decided upon and that is whether or not trade should stand on its own two feet. Trade is trade.

One approach is to treat trade with the Soviet Union just like trade with any other country so that trade takes place for its own sake and that we deal with trade with the Soviet Union just like we do with any other country.

An alternative approach is to say that trade with the Soviet Union is fundamentally different. It is fundamentally different because of security concerns, No. 1; and No. 2, because trade is an integral part of our foreign relations with the Soviet Union, and, therefore, it is so special a case that ordinary sort of trade constraints and concerns have absolutely no applicability. Those are, if you will, sort of polar opposites.

I suspect if you threw out those two different propositions to an audience and asked them what do you think our basic attitude ought to be, you would find a large number of people who would say the first of those two objectives and a very large number of people would say the second of those two objectives.

It seems to me the first cut, if you will, at the problem is in deciding which of those two objectives we want, and, if it is not one of those two, where we are is in the middle, if you will, as an alternative. But until one really articulates what the objective is, it seems to me to talk about long term versus short term or flexibility versus stability is essentially meaningless because one can get stability and so forth under different scenarios.

It seems to me the key question is deciding what the goal is.

Moderator HARDT. We then have not decided what the goal is. Can business operate in an environment in which we have not decided what the goal is?

Mr. LEWIS. I am sure that some business could operate. Specifically, in the East-West trade, business is taking place. The Commerce Department has put out a list of goods you can trade, et cetera.

I think there is an interesting point in your question and I would like to elaborate on Stan's answer, and that is when you are discussing how you formulate a U.S. policy, I am not sure you just have to look at trade sanctions as the only option between war and peace.

This was essentially the choice presented by one member of the National Security Council to a trade meeting we had on this issue and he said, gee, it would be really helpful if the business community sat down and told us between war and trade sanctions which of those actions we could take to get our points across.

That irritated more than a few members of our trade committee, one of whom colorfully characterized that approach as "an abdication of the thought process" and he went home and wrote out a decision notary on the various options that the United States could pursue to make a point about an international development.

He came up with either 25 or 30 different ways—from recalling your Ambassador to sending the spies home. This notary was a bit of "tongue and cheek." I asked him what he meant about the spies and he said well, to get a point across you just declare somebody a persona non grata and send them home.

Mr. JENKINS. That is not so facetious, Howard. the British sent 84 Soviet Embassy members home in one fell swoop once and made quite a point of it.

Mr. LEWIS. Yes, and the point I guess in my answer to your question is that we should not really just be thinking about foreign policy controls as the only lever we have. Certainly there are a number of other levers. For example, in our attempts to reach a developing world nation concerning something we don't approve of, this particular executive suggested if you really wanted to make your point to the elites in that country, you send the students home.

Now I am not saying that I am always in favor of every time you don't like something of sending all the foreign students of a country home, but the point I am trying to make is that to some extent that may be better than putting American workers out of work in Peoria. At least the American worker in Peoria makes out better.

Mr. SIMES. Mr. Lewis made an interesting point about sending spies home. Well, the British sent Soviet spies home. The United States, when displeased with the Soviets sent American spies home, and this is not a joke. You remember that when we were displeased with Soviet behavior under the Carter administration, we decided to close two consulates, the American consulate in Kiev and the Soviet consulate in New York.

Well, the Soviets do not really need a consulate in New York for their intelligence activities. They can use the United Nations staff. But the United States had an American window to the Ukraine in Kiev. Without it the United States has no representation there whatsoever. Now what happened? The American consulate in Kiev is closed and the Americans have no access to the city. The Soviet Consul General in New York went for a long vacation and came back to New York as Deputy Under Secretary General of the United Nations.

This is a story which illustrates that whatever you do, whether soft-line or hard-line, you should be practical. You should ask whom you are punishing. In this case we did not punish the Soviets at all. We punished ourselves and we looked ridiculous in the process.

Mr. MARCUSS. Of course that same point I think could be made about the pipeline sanctions as well. I think it is relatively clear that the Soviets suffered little, if any, harm as a consequence of the episode. It is quite clear that a great deal of harm was inflicted upon the companies, upon the Alliance and upon perceptions of the commitment of the United States to the rule of law and so forth and so on.

On the question, John, of how one goes about making policy, it seems to me it is relatively clear, or at least it ought to be relatively clear by now, that the trade relationship is clearly subservient to the political relationship and it has been I think for many, many years.

I think there was a brief effort, and Mr. Simes would know this better, in the early 1970's to disassociate the trade issues from political issues to a substantial extent. It failed, obviously, and over the ensuing years trade has been looked upon as a device of some kind to seek to affect Soviet behavior or at least to act as a statement about the U.S. attitude with respect to Soviet behavior.

I think one of the key questions to ask in that context is whether there is anything in the years from 1974 forward that would suggest that we have achieved any of the objectives that we may have had. I would be interested in the views of those who are much more expert in this field, but I would be very hard pressed to identify any particular objective that I am aware of that was on the U.S. agenda with respect to the Soviet Union that was in any way, shape or form achieved as a consequence of various trade or financial actions that the United States took.

Indeed, on the emigration side, although one must be, I think, very cautious about attempting to find relationships here, but clearly on the emigration side, emigration has gone down since Jackson-Vanik and not up. So if the purpose of Jackson-Vanik was to increase Jewish emigration from the Soviet Union, it failed.

I think the same would be true with respect to various other matters that we characterize as matters of human rights looking at what was done in 1978, looking at the reaction to Afghanistan and looking at the effort to impair Soviet energy development. To date at least, I think it is very hard to see that any of the actions that we have taken over the last decade of a negative kind have had any impact on any matter of any fundamental concern to the Soviet Union and of interest to us.

Mr. **Jenkins**. It is hard to disagree with anything anybody has said on the panel this morning. I think all the major points are right on target.

There are two questions you asked John that I would like to comment on. One is the concept of a consensus with our allies and, second, is residual cost of the sanctions which have been applied and now lifted at least partially.

I don't agree that there is no value in pursuing a long-range objective or assessment. In fact, I think it is absolutely fundamental that we establish, and I think Secretary Shultz is at long last engaged in this process, as an objective a general philosophical consensus among the Western industrial countries as to the value of trade both in its positive and negative aspects. I think only when that has been achieved can we arrive at a policy of exploiting trade for short-range political objectives.

Stan is right, there can be no doubt either in the Western world or in the Soviet Union that trade and politics are engaged with one another. We can see this in Moscow where there is a clear political objective on the part of the Soviets to try and establish the legitimacy of their transfer of power process and their rather dramatic decision to go ahead with the conference involving 250 major American corporate representatives in Moscow the day of the funeral.

They did go ahead with it and in my judgment they went ahead with it not because of their long-range interest in trade, which was clearly a positive consideration, but essentially because they wanted to demonstrate once and for all the legitimacy of the transfer of power process and it did help them in that regard.

But in terms of consensus with our allies, we have achieved this in defense terms. We have disputes and debates and fights over the individual elements in that defense policy, but there is a general consensus and it does enable NATO to operate. We do have a general consensus with our Western allies on a COCOM list. It does operate and I happen to think it operates rather well and I think Stan agrees with that.

I know of no significant instance when we have enhanced Soviet military capabilities through the sale of Western technology. At least wittingly. There have been some illegal and extra-legal actions carried out against the wishes of the COCOM governments, but generally speaking COCOM has worked and it has worked because there is a consensus. I think we have to broaden that consensus. I think that is what Secretary Shultz is trying to do and that has to be perceived as the lowest common denominator and any unilateral action taken outside of that consensus is doomed to ineffectiveness and costliness to the state that undertakes it. We are the usual perpetrators of that silly policy.

The second thing in terms of residual costs, I think it is very important to recognize the geometric costs that are involved in actions like the sanctions.

Howard, you have in your table a list of projects, including our project at Novolipetsk and Caterpillar's pipelayer sale. You don't list the fact that in the Caterpillar pipelayer sale that Komatsu picked up the project and the contract.

Now that is interesting because Caterpillar lost I think $200 million worth of business which translates out into a couple thousand jobs and that is important. But what is more important in terms of residual cost is that Komatsu was provided with an economic incentive to increase its capacity to make this kind of pipe equipment, invested in it to take advantage of that market opportunity, and now because of the long-range economic effect of that contract they have the capability to expand even more and dominate the world market in pipelayers.

We have created for Caterpillar, which had a leading position in the world market for pipelayers, a competition which is dooming them to second place at best. Although the opportunity is open now for Caterpillar to get back in, it is too late. The Soviets will throw a few contracts to Caterpillar just to try and demonstrate that they are being evenhanded, but the fact is that we have created the infrastructure within the Japanese industry to compete in major pipelayers for the rest of time.

We have done the same thing in terms of Argentina's grain production, the grain embargo which did provide the economic incentive for the Argentines to greatly increase their grain plantings and to establish the infrastructure, the railheads, the port facilities and everything that goes with it, as well as the entrepreneural infrastructure to become a major international grain trader.

Before the embargo we had 75 percent of the Soviet grain market. Today we have roughly 18 percent and we will never get, in my judgment, more than 25 percent again, and that will largely be in corn because the Argentines can't produce corn.

These are long-term residual costs of ill-considered Government intervention in the trade mechanism. I think that they are very serious and figures that I have heard from grain companies speak of a $40-billion cost to the United States agricultural sector of the grain embargo to date and it is still going on.

Moderator **Hardt**. Let me refer again to the long-term question. One of the issues that has been discussed is the combine question, International Harvester. As Howard pointed out, when a company makes a commitment it makes a long-term commitment. Now what is being discussed in that case is a long-term commitment for building facilities over a period of a decade or more. This brings to mind the question of the Dresser drilling bit plant which was at the time a long-term commitment. The same kind of questions may be raised in the case of International Harvester's combines.

Now is it possible to have a part of this Soviet industrial goods market, this capital goods market in areas such as the combine or other capital goods areas in which we have still a comparative advantage? Is it desirable on our part if we are to develop this kind of market to have a long-term policy? I am speaking now specifically of a long-term policy relevant to this kind of particular activity, i.e., a long-term policy on food and agricultural equipment or a long-term policy in reference to some range of industrial developments within this normalized trading pattern. You referred to having an understanding that there is a trade relationship. This can be referred to in terms of the normalized trading relationship.

Mr. **Marcuss**. I think your question almost answers itself. It is not possible to penetrate or sustain a market unless there is a high degree of certainty on the part of the buyer that the transactions that he contemplates entering into and seeing fulfilled in fact will be fulfilled.

Wholly apart from having a general sort of long-term policy is the question of whether once, for example, an export license is issued, or once a transaction goes forward under what is called a general license, whether the United States will at some later point change the terms of the license or invalidate the license.

We haven't even gotten to the point yet where we respect the permanence, if you will, of a U.S. Government decision with respect to a very particular transaction, let alone get to the point where we are prepared to carve out whole sectors for development.

It seems to me to be absolutely essential that if we are to have any prospect for long-term economic relationships with the Soviet Union, and by definition any prospect for any kind of meaningful relationship between the economic relationship and the political relationship, we have got to identify our goals in conjunction with our allies, because otherwise, as Jenks suggested, it makes no sense and it is an exercise in futility. We have to identify the nature of the economic relationship that we foresee, and we have to be reasonably specific about the nature of that relationship. We have to identify the sectors, we have to identify the productive capacity that we are prepared to generate, or help generate, in the Soviet Union and we have to identify the kind of technology with respect to specific sectors that we are prepared to sell.

Then, it seems to me the next step is to achieve a consensus, if you will, with the Soviets as well, that that is the nature of the economic relationship that we are prepared to pursue so that there would be a commitment on both sides, which would necessarily take place in a political context, that this is the kind of relationship we expect to see with the Soviet Union and we expect to develop, and we will commit ourselves to seeing it develop so long as certain aspects of the overall relationship remain satisfactory. We would thereby be conveying two things, it seems to me.

One, is a basic bias toward neutrality and a long-term commitment with respect to the trade relationship; and, second, is the implicit, if not explicit statement that this is conditioned upon other aspects of the relationship evolving and developing in ways that are mutually satisfactory.

It seems to me that unless we begin to talk in those terms, we can't begin to identify what it is that we seek to achieve, and we will continue to be subject to the cross-currents of change in U.S. Government policy and U.S. Government thinking.

Let me just amplify the latter point for a second. It is, it seems to me, largely an exercise in abstraction to talk about U.S. Government policy with respect to the Soviet Union largely because it seems to depend so very much on which individuals happen to occupy which particular positions within this very complicated bureaucracy that we have, and particularly in the area where trade is involved because there are so many different actors with so many different perspectives and so many different pressure points within the U.S. Government where actions can be taken that have fundamental consequences.

People who make export licensing decisions, for example, have an extraordinary amount of power. The decisions are generally speaking relatively technical; generally speaking they are not subject to any substantial review at a very high level. Generally speaking the layman is reluctant to become involved in making decisions in the high technology area and for good reason.

So therefore people at relatively low levels in the U.S. Government, in a wide variety of different agencies, have an extraordinary ability to, if not make policy as such, as a practical matter make policy in the day-to-day decisions that they make. That is a real problem, it seems to me, in evolving an overall general policy.

The Assistant Secretary of Defense who happens to disagree with a generally stated policy has a significant ability to undermine that policy and change its basic shape and direction.

Mr. **JENKINS**. That depends on the quality of the leadership at the Secretary's level I think, Stan, which also varies tremendously from administration to administration.

Moderator **HARDT**. We have a list that was presented in Moscow in November 1982 of goods that are exportable by the United States. Again, things like combines are on this list. It is known from the standpoint of foreign availability that other Western countries have combines, Massey-Ferguson, for example.

From the standpoint of effective leverage on the Soviet Union, what will be the factors that will influence the Soviets in terms of where they will get contracts if Mr. Andropov is indeed interested in addressing his food and agriculture problem and new combines is one of his priority areas? Will he go to a Western country other than the United States because of reliability of supply contracts? Will he go to a West European country because their trading pattern is one that provides more favorable credit as well? Will he go to other areas? In other words, can we find in this present non-agricultural area under present circumstances a basis for trade if it is keyed to capital good exports?

Mr. **Jenkins**. Where the Soviets will go is where they can get the best price, the best quality and the most assured guarantee. Then you take into account after that the current political objectives. I happen to think that Andropov is interested in trying to make some gestures toward the United States at this stage and so International Harvester's combine project, for example, is alive again. The chairman of International Harvester was in Moscow for the conference and had lengthy conversations and that negotiation is alive again.

Although it is allowed on that list to sell combines, a plant which produces combines and includes serial computer technology still requires an individual case-by-case license and it is not assured that this administration will approve that license. So there is still a question mark about it, but I think there is a reasonable chance that International Harvester can have that contract back again if the administration will cooperate. That is a roughly $1 billion over 10-year contract which for International Harvester could make an important difference.

Moderator **Hardt**. Now if we have such contracts, how can we effectively utilize them in our diplomatic relations with the Soviet Union?

Dimitri, I think you indicated that there are ways that they could be effectively used. You cited emigration. Stan said there are no examples that come to mind of effective use. Well, if we are going to square these things, what are areas and what are procedures where we can be effective?

Mr. **Simes**. John, first of all, I agree with Mr. Jenkins that the Soviets are going to deal with International Harvester. I am afraid, unfortunately, that International Harvester is not going to be the principal supplier. It will get an important cut, but unlike in the past the Soviets will make a major effort to diversify their supplies and the Europeans will take a considerable profit in the business. The Soviets do not want to find themselves in a situation when 2 years from now something would happen to Andrei Sakharov and the whole deal would be canceled.

So I think the Soviets, on one hand, are still interested in trading with the United States, as Mr. Jenkins said, not only for economic but also for political reasons, and they do appreciate that it is to their advantage to keep the American business community interested, and if they don't approach the American business community, why should they be interested? But I think that a considerable part of this business is going to be lost, at least at this juncture.

Second, I think that at this point our economic leverage is very minimal because the Soviets are coming to conclude this deal not only for economic but also for political reasons. If they do not believe that the deal is really in their best economic interests, and if they know that they have to pay a reasonable commercial price without any subsidies, and if we are talking about technology which is available everywhere else, then what is the American political leverage?

But, lets say the United States proceeds with this deal, and 10 or 15 deals like it, and the Soviets once again feel that the United States is a reliable supplier. They approach us and discuss our help in their Siberian energy development, and we decide that under certain conditions, we should participate. In this kind of situation, they will think we have leverage and they will think it not unreasonable for us to tell them that, for instance, their withdrawal from Afghanistan, with our participation in the settlement, would be part of the package. And I am talking about telling them this privately and not publicly.

I think it would not be unreasonable at all to tell the Soviets look, we want Shcharansky out, not because you mistreated him, not because it was inexcusable, not because he was innocent, but we just don't want his case to interfere with this deal and to become a controversial issue.

Recently some senior American business executives were scheduled to meet with Mr. Brezhnev to discuss among other topics Mr. Shcharansky. Mr. Brezhnev died and the meeting obviously did not take place. But I still hope that with the right combination of toughness and tactful diplomacy, this tragic case may finally be resolved.

So I believe that there is still some leverage, but you cannot come to the Soviets and say well, we are going to sell you some International Harvester combines of the type which are available everywhere in similar or better conditions, and you make political concessions.

First we have to establish trust: first we have to make the Soviets interested in long-term economic relationships with the United States, we have to tell them what we are willing to offer, and then we can discuss our terms.

Moderator **Hardt**. Do we have to face them with a Western unified position?

Mr. **Simes**. It depends on what you are asking for. I think in certain areas, if they are really interested in a long-term economic relationship with the United States, unilateral American leverage can work. But obviously a unified position would be of great help. The more united we are, the more we can get from the Soviet Union. But I think we have to understand that a tradeoff is involved.

If you are always going to insist on a unified position with the Europeans, you essentially are accepting a common denominator, and the Europeans probably would ask for less and not for more. So consequently, I think in some cases we have to talk to the Soviets unilaterally and, when feasible, we should have a unified position.

What is important is not always to have a unified position, but not to allow a situation when we and the Europeans march in different directions and the Soviets are the only ones who enjoy the picture.

Mr. **Marcuss**. John, some of what has been said certainly suggests that one of the principal problems at the moment is that the way we generally approach the trade side of the relationship is in negative terms. We deny an export license or we terminate an export license. We look at existing transactions and interfere with them in response to Soviet actions with which we disagree.

It seems to me a far more productive approach would be to look at the positive side, the carrot, if you will, rather than the stick, in that it seems to me there is probably a great deal more that can be accomplished if what one tries to do is identify with the Soviets those economic activities and those economic relationships that are of importance to them and, in the context of establishing those relationships, putting on the agenda, if you will, those elements of the political relationships that are important to us as well and discuss those in advance.

The difficulty now is that we develop items on the political agenda after the trade relationship has been established and then go about imposing negative sanctions which have by and large the effect of reinforcing Soviet attitudes in favor of pursuing the very behavior or very actions that gave rise to the sanction in the first place.

So it is a very negative and very variant policy with adverse long-term trade implications and no particular advantage for us on the political side as far as I see it.

A related aspect of this is that the economic relationship of the United States with the Soviet Union is by and large necessarily on our side a private sector relationship and therefore we don't really control the agenda of economic matters that can be put on the table for discussion. It is when International Harvester happens to have a transaction or Caterpillar happens to have a transaction or Dresser or Armco that it becomes possible for us even to begin to think about it.

To put it another way, it is not until they happen to have a transaction that we can begin to think about securing some political interest of our own as a consequence of the economic relationship. That is an endemic problem as contrasted with the situation, for example, where the U.S. Government could go to the Soviet Government and say these are transactions that we are prepared to see take place with the Soviet Union, and we will undertake to encourage them and to assist them and make them come to fruition and in that context put on the table some of the other elements of the political relationship.

This is a systemic problem; we are not going to change it, but that is a basic weakness in our ability to get very much political mileage out of an economic relationship it seems to me.

Moderator **Hardt**. In reference to the often discussed question of reliable supply in grain which President Reagan spoke to in Iowa and Senator Dole raised in Moscow, one of the proposals is to legislate the inviolability of contracts. Now that is a way in effect of intruding a negative negative.

On the positive side one might ask the question if the Soviets give more attention to their iron and steel development and it comes back on our trade agenda are there positive actions that the United States might take vis-a-vis our competitive relationship with the Germans or the Japanese? Do we have any thoughts on this line of strategy?

Mr. **Jenkins**. John, I would like to return to Dimitri's point about whether it is necessary to do things unilaterally or multilaterally. Obviously we need as the leading power in the West to have unilateral capabilities, and I think we do have them.

I just don't think we have them in the trade field, and I will comment on that a little this afternoon, but they are in the propaganda field and the use of Radio Liberty, which is a lot more neuralgic for the Soviets than having them transfer a contract from Caterpillar to Komatsu, and in the military field where we can do things in weapons systems and the status of our draft. For example, actions, if this is the most serious crisis since World War II, as Jimmy Carter described Afghanistan, canceling or reducing Aeroflot flights from three to two a week was not exactly a proportionate response.

So I do think there are unilateral actions we can take, but I think it is very important to recognize that in a cost-benefit analysis, both political and economic, unilateral actions taken in the trade field even where we have clear leadership in that given product line will establish the economic incentives for us to lose that leadership. Therefore in trade terms we cannot effectively unilaterally have any impact on the Soviet Union.

Mr. SIMES. Let me just clarify what I said. I did not mean to suggest that it is wise for the United States to have unilateral sanctions against the Soviet Union. I was talking about positive leverage. I was talking about discussions before the contract is signed, when the Soviets want something from us. And future signed contracts should be observed unless there are most extreme circumstances.

Let me make a related point. I think we have to review our whole attitude to the business community's role in trade with the Soviet Union. Somehow it became almost an indication of bad faith and lack of appreciation of national interest for American businessmen to indicate their interest in trade with the Soviet Union. We may again argue for hours about whether trade should be linked with politics. Realistically speaking, it is linked.

But I think it is important to understand that Soviet Jews would never have left the U.S.S.R. without Senator Jackson, but they also would never have left without the business community. Along with Senator Jackson gaining the leverage, there has to be a group of American businessmen willing to trade. I think somehow this has been totally ignored in our public discussions.

Mr. MARCUSS. John, may I make one other point that seems to me perhaps very important in clarifying some of the debate. We use the word "trade" pretty loosely. There is a difference of course between trade and investment, and a great deal of the current objection in the United States to the economic relationship with the Soviet Union is based upon the fact that there is investment in the Soviet Union that is regarded as for one reason or another adverse to U.S. economic and security interests.

I don't have the proposal here, but it seems to me that there is a degree of imprecision there that masks a number of very important issues. There is a big difference between trade and investment from an economic point of view as well as a political point of view.

Mr. LEWIS. Kempton Jenkins mentioned the cost of unilateral controls in areas that we had comparative advantage or substantial comparative advantage, and I would just like to cite an example to show people the specifics.

We have a real advantage in the production of drill bits to drill oil wells. Other people produce these drill bits, and I am told by the people in this industry that the one critical competitive factors is the reliability of these drill bits. Once you get a drill bit 2 or 3 miles down a hole, if the thing breaks it is a real problem to get it back up and it takes a lot of money.

Point No. 1 is there are a lot of oil wells being drilled in Russia right now and people in the American drill bit business point out that our unilateral sanctions often take us out of the drill bit business and allow competitors to move in and prove their products. That makes a big difference the next time those competitors want to sell some place else in the world and they can turn to another market and say our drill bits work 4 miles down that oil well hole just as well as the American's did. So there is a real cost even in the high technology, let alone International Harvester, which is more at the low end of the high technology or medium technology.

Moderator **Hardt**. I cited Harvester because it is an active issue. It is in the category of exports more likely to be approved and it is a capital goods area in which we presumably have a comparative advantage.

I would like to return to President Reagan's statement about developing new rules for economic relations with the Soviet Union and singling out energy policy, the strategic controls and credit policy and ask if we couldn't clarify this a bit more. Let me start with credit policy and invite several of you from the audience who are quite knowledgeable on this subject to add to our insights.

There is reference to preferential treatment in terms of credit and subsidized credit. I think it is important to try to identify what this means. Is a government guarantee preferential treatment? Is Hermes credit guarantee preferential treatment? Is any Export-Import Bank involvement of credit that the Germans provide preferential treatment, or is it preferential only if the treatment involves a net transfer of resources from tax funds? What does one mean by, and I am not asking you to look in the mind of the President on this, but what reasonable criteria are there for such measures? What are the more detailed questions that will be faced when there is a discussion of what President Reagan means by identifying preferential credit as an issue for study?

Maybe, Jan, you might want to comment to that. Can I pull you in, or Marty or Bill? I will throw out a broader net to audience participation. This is a question that I think we have to deal with because when we are talking about particular product and credit lines we are talking about the other terms of the trade agreement, it is the whole relationship.

When we say that our drilling bits are comparatively advantageous, it is not just the quality of the drilling bits, it is the total trade package that sells or doesn't sell the product. It is also the implications of export controls and the legal implication. In this context the credit questions have been brought to the fore. Can we throw some light on that so we can see what the issues are that are on the table, or should be on the table in discussing this?

Yes, Jan.

Mr. Vanous. I would say that there are a number of methods of subsidization. A straightforward case would be the Austrian case where a fixed interest rate is given from commercial banks and the government explicitly pays a 2-percent margin that cuts the rate, say, from 9 percent to 7 percent.

Another possible subsidy would be where the government agency directly grants a credit that falls below the market interest rates. The calculation of government sudsidy is quite complicated because most of these credits are at fixed rates, whereas the market rates tend to change. For example, some people still talking about huge subsidies while LIBOR has fallen to 9½ percent. The U.S. prime rate is also down and a lot of these subsidies are rapidly disappearing.

Another possible subsidy would be if you insure loans to the East with significant risk and in fact something goes wrong and the Western government picks up the tab. That has to be arrived at on a case-by-case basis. If it is in Poland, it is clear that this subsidy through insuring business was huge because in fact Poland was not able to pay and now the Western governments are footing the bill.

In the case of the Soviet Union, the subsidy is there if the transaction is insured, but there is a very low probability that the Soviet Union will not be able to honor its financial obligations. Therefore in essence by insuring it we are not artificially lowering the rate.

The additional point is that it is also very difficult to calculate the subsidies because loans are made in different countries and there are different inflation rates and the whole issue becomes quite complicated.

Moderator **Hardt.** You are also implying that the relevant financial data are not a matter of public record, and that is an important point to make.

Mr. Lewis. Several points on the credit issue. It is a very thorny problem obviously to discuss what is a subsidy and how you fit in a guarantee. But backing away from that type of technical problem, I think it is important to realize that in capital projects that we are talking about, or often are talking about in trade with the Soviet Union, that export credit is the name of the game and we cannot divorce our overall export credit policy or lack thereof from the East-West trade issue.

Second, there are divergent systems in this world of export credits. For example, it is my understanding that, with perhaps some exceptions, that in the export financing transaction out of a German bank they have to get Hermes insurance. Well now, are you going to include that as a subsidized export finance transaction in your discussion of the East-West trade? That is a very complicated question when you are beginning to get into the workings of the German commercial system or export financing system and you are beginning to really hit at the fundamental way in which the Germans finance their exports. So that is a tremendously difficult issue.

Moderator **Hardt.** Are you saying that the normal trading practice of many Western countries would be defined as preferential credit policies?

Mr. Lewis. Yes.

Mr. Jenkins. We are almost the sole exception.

Mr. Lewis. All medium term transactions, medium term meaning 2 to 5 years, have some sort of government support, insurance guarantees or in some cases subsidies. Now that is not just the Soviet Union. That is with the world.

Moderator Hardt. So in terms of President Reagan's third task of an export credit policy, we would go to the other Western trading countries with what is a different normal policy to negotiate and either one or the other of us, if we get agreement, has to give up our normal trading relationship vis-a-vis credit.

Mr. Jenkins. Those negotiations on a global basis in terms of global practice have been going on through three administrations, John. There is a Western culture of negotiations on this point and a consensus is gradually emerging and some progress has been made to try and standardize or at least to define and recognize where the differences are and try to assess the value of those differences.

In due course I think it is expected and reasonable to expect that the Western trading countries will have a more or less standardized range of financing incentives, guarantees, insurance schemes and so forth, and we can judge each other's relative advantage, but that process is still going on and it is one of the things that former Secretary Haig tried to start at Versailles and Secretary Shultz is working on now, but it goes back to Chuck Robinson in Kissinger's administration. He did make some progress in that regard and we have in place certain benchmarks which we agree on.

Moderator Hardt. In essence gentlemen's agreements were involved.

Mr. Jenkins. Any multilateral agreement is a gentleman's agreement, and it is a Western multilateral agreement by definition.

Mr. Marcuss. The so-called gentleman's agreement though has a very real impact, and it is a very real agreement from the standpoint of U.S. countervailing duty law. For example, U.S. countervailing duty law regards as an export subsidy and therefore countervailable under the U.S. countervailing duty law any government credit, below-market credit, that is given by a foreign government. We do not, however, countervail against any credit that meets the guidelines established pursuant to the gentleman's agreement and this arrangement has been agreed upon in the GATT. So we have in place a very clear understanding as to what constitutes a subsidy and what level of subsidy we are prepared to tolerate among the OECD countries.

But it seems to me a key question is really what does President Reagan mean when he talks about nonpreferential credit terms, and I think you put your finger on it.

However, it was suggested a while ago that we should not divorce East-West credit policy from worldwide credit policy.

Mr. Lewis. You cannot in the real world.

Mr. Marcuss. And you really cannot in the real world, that is correct. Money is a very fungible commodity. Therefore, if the Reagan administration is talking about nonpreferential credit terms for the Soviet Union, it is talking about a nonachievable objective.

Mr. Lewis. I think one of the objectives they were after, and maybe they have achieved it to some extent, is that the Soviet

Union should not be given under the OECD agreement the rates that developing countries get and at least make them pay the rates that the industrial world countries get.

Mr. JENKINS. That is an achievable agreement.

Mr. LEWIS. You are right, under the OECD they did agree to up the rates, but I would look very closely at some of the details of that. There is a tendency to "grandfather" things in these agreements and the Europeans seem to have much longer grandfathering memories than our Eximbank does.

Mr. MONTGOMERY. I think one point also should be kept in mind. By and large only a relatively small share of the trade is actually financed with official credits or guaranteed credits. The bulk of it is straight commercial financing.

Mr. JENKINS. The most important thing about Exim's role would be in long-range projects like Siberian energy development or in the shorter run the political legitimacy which Exim exposure bestows on the customer which is valued a lot by businessmen making decisions. It must be all right to do business there because the Eximbank is there and, you know, we are not going out on a limb, and that is the kind of element that looms very large in an American businessman's mind when he is dealing with one of the more exotic customers.

Moderator HARDT. We should for the record note that the Eximbank window is closed as is the CCC window by virtue of the aforementioned trade act. Also, I think we should from the standpoint of the record give Stan an opportunity to refer to his analysis of the Stevenson amendment and clarify what it was intended to do and how it could be used.

The public characterization of the Stevenson amendment is often somewhat different than the chapter you wrote characterizing it,[1] as you could as one of its architects. As it is relevant to the potential future of availability of Government credits, it might be useful to say a word about that and then for the record we can reference your previous writings on this subject.

Mr. MARCUSS. I think it is fair to say, although this is a point that has been lost in whatever history books there are on this subject, that the Stevenson amendment was intended as a substitute for Jackson-Vanik. Stevenson did not approve of Jackson-Vanik. He did not like the idea of tying credits to something as discrete as Jewish emigration. He did not believe that Jackson-Vanik would work.

So as a consequence, what he looked for was some alternative. The alternative that was developed was an alternative that placed a ceiling on the amount of Exim credits that could be extended in the future. That ceiling was $300 million, a figure which at the time exceeded all known Soviet applications, or to put it another way, all known applications for Export-Import Bank credits to the Soviet Union.

As you may recall, about $180 million of Export-Import Bank credits had been extended at that time, and there was on Exim's books applications for additional credits in amounts less than a total of $300 million additional credits. Indeed the calculation or the judgment was that under the ceiling of $300 million there would be another 2 to 3 years where those funds could be provided by the Export-Import Bank before it would be necessary to come back to the Congress.

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[1] See: "Financing of East-West Trade: The Political Economy of Government Credits and National Interest," edited by Paul Marer (Bloomington International Development Research Center, Indiana University), 1975.

That is the second point about the amendment. It was not an absolute bar to additional credits. All it required was that the executive branch come back and seek additional authorization from the Congress for additional Eximbank funds for the Soviet Union.

Now, as we all know, despite Stevenson's intentions, events didn't work out as he had hoped. Stevenson became not a substitute for Jackson-Vanik, but a piece of legislation that was in addition to Jackson-Vanik. I think that was a consequence of the difficulties with the parliamentary posture at the time. It had also to do with the fact that both the Senate Banking Committee and the House International Relations Committee were meeting in conference on the Export-Import Bank legislation at the same time as the House Ways and Means Committee and Senate Finance Committee were meeting on the Trade Act legislation.

So you had literally several doors away from each other in this very building two conference committees going on at the same time trying to deal with the same issue. It was impossible to coordinate the two, and indeed both conferences finished their work within a day of each other, and both produced their respective provisions. It was not possible in that environment, given the lateness of the sessions—this was just toward the end of December of 1974—for Stevenson's strategy, such as it was, to come to fruition.

So that kind of in a nutshell is the story of the Stevenson amendment. There are lots of little points of elaboration that could be made, but I think it is a mistake to characterize Stevenson's effort as an effort to terminate Eximbank credits. Indeed, he was hopeful that the Eximbank could be used affirmatively and more positively as a carrot once the administration had been put on notice.

Mind you, this was a dispute in large part between the executive branch and the legislative branch once the administration was put on notice that there were not unlimited funds available through the Export-Import Bank and that it would indeed be necessary for the administration to put on the agenda aspects of the overall political relationship if it sought to have additional funding made available for the Soviet Union through the Export-Import Bank.

I had a question I wanted to ask Mr. Simes about the Soviet reaction. I think you said something to the effect that Kissinger did not pursue the emigration issue with the Soviets not because he believed in its morality or any other aspect but that he was simply conveying to the Soviets the facts of life. I think that is what you said.

Why wasn't Kissinger able to convey to the Soviets one fact of life; namely, that some legislation was going to be enacted? I am surprised frankly that the Soviets were surprised that legislation was enacted.

Mr. **Jenkins**. I was doing Kissinger's legislation at that point.

Mr. **Marcuss**. That explains it, Jenks. [Laughter.]

Mr. **Jenkins**. In fact, I was the one who was running back and forth between those two conferences trying to make sure that what happened did not happen. I can show you the scars on my back reflecting Secretary Kissinger's reaction to the results. [Laughter.]

The Department and Secretary Kissinger did tell the Soviets and they made their own assessment. I mean Dobrynin was in contact with a number of people on the Hill and they knew there was going to be legislation, and in fact they accepted the legislation reluctantly. What they didn't accept was the piling on in the first instance of the Stevenson amendment. I agree with you, it did cover $300 million and that was the business on the books, but their entire interest in a trading relationship with us was in a decade kind of a span focused centrally on the Siberian-Central Asian energy development complexes and they were looking for multibillion project financing as were the American energy companies who were involved in that. So it did remove a tremendous incentive from them.

The third thing was, of course, Harry Byrd's amendment on the Eximbank which prohibited any Eximbank activity or exposure in the Soviet Union connected with fossil fuel development. That was passed without any hearings. It was introduced on the floor at 11 o'clock at night on New Year's Eve about an hour before Congress went home and it carried in a typical example of congressional responsibility in those late-night sessions and that was the final straw.

On top of that there was the public press conference by Jackson and Richard Perle when they came out of the White House bragging about the fact that they had brought the Soviet Union to its knees. Those things made it impossible for the Soviets to go along with the trade agreement and they informed us that the deal was off.

They had agreed to the Jackson-Vanik amendment. They had even agreed to live with the Stevenson ceiling which, as I remember, had gotten up to $600 million by the end—we had a number of exchanges which Kissinger had in fact signed off on.

I thought the Soviets were remarkably flexible. None of us would have predicted that the Soviets would have gone along with as much as they did. But the cumulative cost of three unexpected initiatives broke the camel's back and nobody can say it was the Stevenson amendment which was, indeed, well intended. Stan and I used to negotiate on behalf of our principals on that very subject. Nor was it the Byrd amendment alone. I happen to think the Byrd amendment was probably the most important or the Jackson-Perle public press conference taking credit for it all. But those things in toto did break down the agreement and it set us back considerably. Jewish emigration started downhill. We lost $800 million of lend-lease repayment which the Soviets had pledged and our upward trend in the Soviet marketplace turned around also.

Mr. **Simes**. I think this is a very good account. Let me add something else. I think the Soviets always had rather dark suspicions about Senator Jackson's and Mr. Perle's motives. They were not sure whether they were after greater freedom of emigration or whether they were trying to sabotage détente and United States-Soviet trade.

It is true that the Soviets accepted the Jackson-Vanik amendment and they were advised by you and by others that the amendment would be passed, and the Soviets had no doubt whatsoever that the amendment would pass.

What disturbed the Soviets, in addition to the Stevenson amendment and the public performance by Senator Jackson on the White House lawn, was the specific list of requirements which Jackson presented, a list which made rather clear to the Soviets that they had no way of complying with the Jackson list.

Specifically, for a number of months there was a discussion of this 100,000 ceiling. This ceiling was mentioned to the Soviets as a target. It was suggested to the Soviets that according to American estimates roughly 100,000 to 150,000 Soviet Jews had received invitations from Israel which they requested. Accordingly, an argument was if the Soviets would allow reasonably free emigration, 100,000 people probably would leave.

The Soviets gave assurances that they would allow reasonably free emigration. They never gave assurances of specifically 100,000. They gave a different assurance: that there would not be a greater rate of refusals than in the past. And since they were arguing that they were allowing 96 to 98 percent to leave, not necessarily immediately, but at least in the course of 3 to 5 years, this 100,000 was not an unreasonable figure.

Obviously, the Soviets have never disclosed how many people have applied. We have no way of knowing. Moreover, we do not know how many who received these invitations indeed intended to use them. We were not entirely aware of how many applications were involved. So consequently the Soviets possibly were not sure at all that they would have to let 100,000 people leave.

You also have to be aware that the Soviet visa office has a limited capacity to process people. That is especially true about provincial visa offices. Soviet customs would have no way of processing 100,000 people leaving the Soviet Union in the course of the year.

In short, when Senator Jackson said that he would not be satisfied with less than 100,000, he essentially told the Soviets, you have no way of complying with this agreement. This is the way I understand it. The Soviets already had enough evidence to take Jackson quite seriously and they decided there was no point in trying and that, whatever they did, he would be against them.

They also were quite disturbed and they complained to the administration, and Mr. Jenkins would remember this, that what they perceived as their major concession was in no way used to their credit. Instead of saying well, the Soviets have relaxed the emigration practices and how nice and how wonderful, Senator Jackson said their practices are disgusting, but we pushed them into the corner and now they have surrendered. This is not what the Soviets expected.

Mr. MARCUSS. On the question of whether the Soviets accepted the Jackson-Vanik amendment though, there is a question of fact. There was the Gromyko letter so-called that Kissinger had been delivered to Kissinger sometime I believe in the summer of 1974 and that Kissinger did not disclose to the Senate Finance Committee at the time the hearings took place on the Jackson-Vanik amendment.

As I recollect it, and my recollections could be faulty, I believe that letter said that Jackson-Vanik was unacceptable to the Soviet Union. Am I wrong in that?

Mr. SIMES. The Soviets said that it wasn't acceptable but they also said something else, that legislation in the U.S. Congress was an American internal affair as long as they were not asked to respect this legislation and to observe it.

So consequently, the Soviets concluded that it was unacceptable, and yet in practice they put together a package which would satisfy the requirements of the Jackson-Vanik amendment. There was no contradiction whatsoever. The Soviets at no point said publicly or even privately that they would comply with the Jackson-Vanik amendment, but they were saying that they were willing to make, if you will, commitments which would in effect allow the administration to satisfy Jackson. The Soviets were dealing with Kissinger and not with Jackson.

Mr. JENKINS. It is interesting that the law doesn't require the Soviets or anybody else to accept Jackson-Vanik. The law requires the administration to state that it has received assurances. We came up against this with Romania and Hungary in subsequent cases where MFN [most-favored-nation] was debated in Congress and with the Chinese. It never was a relevant consideration of the Chinese because Jackson personally asked Deng Shao Peng at the Chinese Embassy here what are you going to do to comply with Jackson-Vanik? I was on the outskirts of that conversation and afterwards I asked Senator Jackson about it. He said it is very simple. He said Deng Shao Peng looked at me and said if you would like a million Chinese in Seattle, I will have them there Monday morning. [Laughter.]

And that was in a sense the assurance package. With the Romanians we had a statement from the Romanian Government that their constitution provided for free emigration and that they intend to abide by their constitution. But privately they said we will treat applications in such and such a fashion and so many people will be allowed and so forth. So these things were essentially done in a typical diplomatic way, that we did not insist on a public embarrassment on their part and they met the substance of their requirement that we had put forth. We had that same kind of package, in fact more specific, with the Soviets in hand than anything we ever got from the Romanians or the Hungarians who now have MFN.

Moderator HARDT. That raises the question of the flexibility of the waiver provisions which came up later when Senator Stevenson was going to modify the Trade Act and the Stevenson amendment was in effect to be repealed. In that sense the issue that came up was the changing of the number of years I am speaking of the Stevenson-AuCoin amendment so that the waiver provision would not have to be addressed annually but every 2 to 5 years.

But the question that I think is relevant to raise here is whether there is enough flexibility within the legislation so that assurances can be provided by the Executive that are not written, that are assurances that the Executive establishes to be in his judgment adequate.

Mr. **Jenkins**. He amended the charge in the Romanian case against accepting any assurances short of risk assurances because he felt it was precedential for dealing with the Soviet problem.

Moderator **Hardt**. But written assurances are required because of that precedent.

Mr. **Jenkins**. I am not sure they are. I don't think we ever got written assurances from the Hungarians, for example.

Mr. **Simes**. In 1979 when Senator Stevenson considered different ways to grant this waiver, the Soviets increased the emigration to 51,000 at a rapid rate. Of course, general improvement in United States-Soviet relations also had a lot to do with that. But it is quite clear that the Soviets were willing to increase the emigration when the United States displayed flexibility and not when the United States proceeded with a very hard line.

So I think realistically speaking, if we decide at this juncture that we want to increase trade—and I am not sure that this would be a good idea—we should find some way to grant the Soviets a waiver, and it is going to be more difficult because, let's face it, the Soviets have killed emigration.

For many years they were kind of uncertain. They did not know what they would get in return as long as they displayed some modicum of flexibility. Now emigration for all practical purposes is killed. To start it once again is going to be much more difficult. It would require a new political decision in Moscow, and let me say that obviously whatever Mr. Perle and Senator Jackson have done, Soviet behavior is entirely uncivilized. But those who provoke the barbarians without thinking about the consequences of their actions should share the responsibility with the barbarians. [Laughter.]

Moderator **Hardt**. I would like to note explicitly that this is a closed meeting and it is by invitation and that what people have said here, as indicated by the candor, is going to be a part of the record after they have had a chance to look at it. Therefore you can quote Dimitri directly, but please be circumspect about direct quotations of individuals before they have had a chance to look at their own record.

Do you adhere to those injunctions?

Mr. **Marcuss**. I won't quote the barbarians. [Laughter.]

Moderator **Hardt**. Well, it is often a question of who identifies who the barbarians are.

We will continue the workshop this afternoon at 1:30 and we will direct our attention particularly to the economic aspect: the utility and the record of sanctions, the question of the importance of trade to the Soviet Union dependency and vulnerability, and the significance of the impact of variations in trade. We will also continue some of the themes that we have discussed this morning.

Thank you.

[Whereupon at 11.50 a.m., the workshop recessed, to convene at 1:30 p.m., the same day.]

AFTERNOON SESSION

The workshop reconvened, pursuant to notice, at 1:45 p.m., in room EF-100, the Capitol, John P. Hardt, associate director for senior specialists, Congressional Research Service, moderating.

Moderator **HARDT**. We would like to reconvene the workshop on the premises of East-West commercial relations.

As was noted in Senator Percy's introduction this morning, the issue of East-West commercial relations, especially the pipeline issue, was a very divisive issue between the Congress and the executive. It is also a very divisive issue between the business community and the executive, as indicated by the testimony and discussion of Mr. Lewis from the National Association of Manufacturers this morning and, needless to say, it is a divisive issue among the Western industrial countries or our economic alliance.

The actions taken by the President on November 13, 1982 removed the sanctions applying to U.S. companies operating abroad in and foreign affiliates and put the issue back on the track of discussion, negotiation, and development of a unified policy in terms of the Federal Government, the broader business and government community and among the Western industrial countries.

We will proceed to discuss the economic aspects of the sanctions, their utility, the role of trade and diplomacy, the participation and the impact of Western trade on the Soviet economy, and dependency and vulnerability in this afternoon's session.

Each of the principals will provide highlights of their written comments which are available on the table, and then we will proceed with some discussion first from the table and then include those in the broader group here.

Edward Hewett of the senior staff of the Brookings Institution has his doctoral degree from the University of Michigan and has been engaged in research on the Soviet and East European area, most recently focusing on the assessment of economic developments in Hungary and in the Soviet and East European energy area and also particularly on the issues of this workshop. So we will start with Ed.

STATEMENT OF ED. A. HEWETT, SENIOR STAFF, THE BROOKINGS INSTITUTION, WASHINGTON, D.C.

ECONOMIC UTILITY OF EMBARGOES AND SANCTIONS

Mr. **HEWETT**. I will offer several brief comments on the costs and benefits of economic sanctions. These comments are my way of thinking about what we have gone through the last year, in order to make some sense out of it and to try to draw some lessons from it for the future.

I would just say at the start, in order to establish a vocabulary for what we are talking about, that "economic sanctions" can encompass a broad range of measures which one country may take against another: embargo on the trade of a commodity or group of commodities, removal of MFN status, removal of access to seaports or airports, abrogation of trade and cooperation treaties or the imposition of special tariffs applying only to the imports of the country against which the sanctions are being taken.

There can be a number of purposes to which sanctions are applied, which I will classify in two groups: economic purposes and foreign policy purposes. A country may choose to impose economic sanctions on another country for such economic purposes as trying to stop that country from subsidizing steel exports or agricultural exports (to take a topical example). On the other hand, foreign policy purposes of sanctions could be the use of economic sanctions in an attempt to induce the Soviet Union to leave Afghanistan.

The United States really provides the most important recent examples of using economic sanctions for foreign policy goals, and this is the type of sanction I will discuss today, leaving aside the imposition of sanctions in order to achieve economic policy goals.

The clearest and most important illustration of economic sanctions for foreign policy reasons is the U.S. embargo on oil and gas technology exports to the Soviet Union imposed on December 29, extended on June 18 to West European firms and to U.S. affiliates in any country, and removed on November 13 of this year. Our experience with that embargo is rich with lessons that future policymakers should contemplate if they decide at some point once again to set off down this road. This brief statement addresses four lessons which are implicit in the experience we have had.

The first lesson is that the costs and benefits of embargoes for foreign policy reasons are in different currencies. It is an obvious point but one that needs to be thought about a little bit. The costs of an embargo are for the most part economic and they are countable. One can see things like lost jobs, lost profits, lost export revenues, a decline in market share and so on. They can be counted up and even a dollar figure can probably be put on them over a period of time. There may be political costs to an economic embargo within country, but those will probably be secondary and will flow from the economic costs.

The benefits—the other side of this equation—are in a different currency. If there are any benefits they are changes in the policies of another country. It could be foreign policies or it could be domestic policies. In the case of the Soviet Union, it could be pulling out of Afghanistan or it could be Jewish emigration.

It is hard to identify these changes and furthermore they can't be quantified. It is very difficult to put a dollar figure on such changes. That means embargoes for foreign policy purposes involve inherently incomparable costs and benefits, and therefore it is quite difficult to judge whether or not there have been net benefits from such embargoes.

The other point I would make about the benefits of embargo is that they are far less certain than the costs. If an embargo is imposed, such as the one that was imposed on December 29, the costs can be identified rather quickly and with a fair amount of certainty.

On the other side of the equation, to try to identify the benefits, the problem is that benefits will be the outcome of a very long, rather fragile chain of reasoning. My written statement contains an example of such a chain which I will summarize here.

One of the purposes of the embargo we took against the Soviet Union, not the officially stated purpose, but nevertheless one of the important purposes, was to influence Soviet defense expenditure.

The chain that lay behind that goes something like this. The U.S. imposes an embargo on exports of oil and gas technology and the Soviets can no longer obtain that technology from the United States. They can't replace the technology with equipment from Western countries or from the East European countries or from their domestic industry. That then forces them to slow down gas pipelines and oil drilling programs. That slows the flow in oil and gas sometimes in the future. That forces the Soviet to reduce energy exports. That reduces hard currency earnings. That reduces imports of technology from the West. That reduces GNP growth rates, which means they either have to cut defense expenditures or consumption. They choose to cut defense expenditures because of the unacceptable political risk of cutting consumption.

This is a nine-link chain which is oversimplified for the sake of brevity. Anyone who is familiar with the Soviet economy knows that at every link in that chain the Soviets have alternatives. They are not forced to go to the next link in the chain. So the probability of getting from one to nine is extremely low, and in fact I suspect it is zero.

Whether or not you agree with the way I have laid that chain out, I think you have to admit that the potential benefits from an embargo are far less certain than costs and should be proportionally higher to compensate for that.

The second lesson from this embargo experience is that the costs and the benefits are distributed much differently. The costs of an embargo are highly concentrated in a few firms and fall on a few individuals. For example, in connection with the recent embargo on oil and gas technology very few firms absorbed most of the cost: Dresser, General Electric and Caterpillar, to mention three. For most U.S. citizens the costs were nil. There might have been some indirect costs that were passed on to them over time, but they were quite tiny.

The benefits, on the other hand, to the extent there are any, are diffuse. There are very few individuals receiving large benefits from an embargo. There may be some who place a very high value on whatever changes in foreign policy evolve, but I suspect that would be very few people indeed.

Such an embargo is similar to a tax for defense or for any other public good. However it is an extremely unfair tax because a few almost randomly chosen firms and groups of individuals pay for this public good that we are purchasing—changes in the policies of another government.

A third lesson from the embargo experience is that the costs may linger far beyond the period where the benefits have dissipated. The costs of the embargo—which are lost jobs, exports, profits and so on—only last as long as the countries who are affected by the embargo attempt to purchase goods from other countries to insulate themselves from further embargoes and that can be a very long time, except in the case of commodities that are perfectly homogeneous in which case an embargo really doesn't matter any way. With that exception, the cost to the country imposing the embargo can linger for a long time as the country that is the target of the embargo diverts purchases to third countries and away from the country that imposed the embargo.

On the other hand, the benefits, that is the policy changes that came about, could be quite short-lived. In the first place, if an embargo works it means that somehow one country has coerced another to change a policy which its leaders do not otherwise want to change. It is certain that as soon as it is possible they will try to circumvent that embargo and revert to their previous policies. For any country as large as, for example, the Soviet Union the options are broad enough that they can do that rather quickly. So the benefits are likely to dissipate rather quickly.

Briefly, the fourth lesson from our recent experience with embargoes is the costs can fall on third countries who are not involved in any other way. An embargo is similar to a poorly guided missile with multiple warheads. One of the warheads may hit the target, but a number of the other warheads can go around hitting bystanders and in the process impose on them some economic costs which can become political costs for the country imposing the embargo, a lesson I do not need to belabor in light of what has happened to us in the last year.

Let me now just outline what conclusions from this for what U.S. policy should be on the use of embargoes as a foreign policy instrument.

Each of the lessons discussed here suggests a consideration which policymakers should think about when they are contemplating an embargo. First, they must spell out the costs and benefits of any potential embargo quite carefully, and the benefits should be quite large because the probability of obtaining those benefits is rather low.

Second, a mechanism should be established to compensate those who will incur the costs of the embargo, so that this is not a random tax for a public good.

Third, the costs and benefits should be computed over a fair period of time, which for some commodities could be 5 to 10 years.

Finally, the costs imposed on third countries should be estimated to assess the political consequences of the embargo.

I suspect that any government which goes through these four factors and gives them careful consideration will not use an embargo in an attempt to achieve a foreign policy goal. The only exception I can think of to this might be a case where this is the only instrument available to protest what is particularly onerous policy that has been taken by another country.

The United States as a great world power is rarely in a single option situation and—in general it makes sense for us to pursue other options other than embargoes. I am thinking mostly of diplomatic options, but I would say, and this is my final point, that whatever we do—whether we choose to try to use an embargo or a diplomatic means to influence the policy of another country—we must realize that in fact it is very difficult indeed to coerce the leaders of another country to change policies they regard to be in their own interest, and it is particularly difficult when one superpower is dealing with another one.

[Mr. Hewett's prepared statement follows:]

PREPARED STATEMENT OF ED. A. HEWETT

(I) Economic sanctions taken by one nation against another can encompass a broad range of measures: an embargo on exports of a group of products, removal of MFN treatment, imposition of special tariffs, withdrawal of access to sea and air ports, or cancellation of treaties on trade and cooperation. These measures can be taken in an effort to achieve some economic policy objective (reducing imports of cheap steel from Europe and Japan for example) or for some foreign policy objective (for example including the Soviets to leave Afghanistan). Whatever the reason that sanctions are taken, they have costs and benefits associated with them which it is important to assess since it is those which determine the success or failure of the policy.

The most recent and notable attempts to use economic sanctions as foreign policy tools have come from the United States Government, in particular the post-Afghanistan embargoes on some grain sales and energy technology in the Carter administration and the Reagan administration's sanctions against Poland and the Soviet Union. Both episodes raise serious questions about the utility of economic sanctions as a foreign policy tool, indeed one could question if in either case the benefits exceeded the costs. The issues involved are all easily seen in the Reagan sanctions, most notably the embargo of December 29, 1981, on the sales of oil and gas technology to the U.S.S.R. The officially stated purpose of this embargo was to induce the Soviet Union to foreswear its opposition to the development of a democratic labor movement in Poland, the theory apparently being that then the Polish Government would allow Solidarity to move ahead in its transformation of Polish society. This was an attempt to use economic sanctions to accomplish a foreign policy goal of the U.S. Government; in addition there were other foreign policy considerations involved (such as placing economic pressure on the Soviet Union in order to increase the burden of their defense expenditures). This policy took on a new and much nastier appearance on June 18, 1982 when the Reagan administration announced that European firms using U.S. technology to produce oil and gas equipment were also subject to the embargo, and would lose their right to do business in the United States if they violated it. In this instance the United States Government sought to use economic sanctions to force its allies to concur with U.S. foreign policy on the Soviet Union and Poland. On November 13, 1982 the embargo was removed.

This brief statement reviews some of the lessons from the experience of this last year, focusing on the costs and benefits of using economic sanctions as a foreign policy tool.

(II) I see four important lessons emerging from the recent U.S. experience with embargoes: (1) the costs and benefits are in different "currencies," (2) costs of embargoes fall on a few people, while benefits are diffuse, (3) costs of embargoes decline more slowly then benefits, and (4) third countries, although neither the initiator nor the target of an embargo, may nevertheless incur costs from the policy.

The different "currencies" in which costs and benefits are counted up derive directly from the fact that the embargo is an economic weapon used for a political purpose. Thus the costs are economic and countable in lost exports and profits, higher excess capacity; lost jobs, and so on. One could, presumably, come up with a dollar figure for the costs to the United States as a whole of the embargo on oil and gas exports to the U.S.S.R.

The benefits, however, are not in a form which can be counted in dollars. Embargoes used as foreign policy instruments are designed to force other countries to adopt policy measures more to U.S. liking, or at least not to abandon policies which the U.S. Government supports. Such changes in policy will be difficult to identify since policy changes are not always announced, especially when adversaries (or friends) are visibly applying pressure to force changes. Even when such changes are identified, there is no way to put a dollar amount on the political benefits obtained; nor is it easy to assess the political costs of the economic effects on the U.S. economy of an embargo. Embargoes (and economic sanctions) used for foreign policy purposes are, therefore, inherently policies whose costs and benefits are difficult to compare.

Furthermore the benefits of an embargo policy are far less certain than the costs. When an embargo is undertaken, the costs are fairly immediate and easy to see: some factories lose large export orders, production lines are shut down, and workers laid off. But the foreign policy benefits of an embargo, if they occur at all, will only come at the end of a very long, fragile, and uncertain chain of events. Consider for example the attempt by the U.S. Government to use the oil and gas technology embargo to force the Soviet Union to change its policies on defense expenditures (also a goal of the U.S. embargo). Presumably the theory behind this goes something like the following: (1) the Soviets can no longer obtain oil and gas technology from the United States; (2) they cannot replace that technology with equipment from other Western countries, Eastern Europe, or domestic industry; (3) that forces the gas pipeline and oil drilling programs behind schedule; (4) that slows the flow of oil and gas sometime in the future; (5) that forces the Soviets to reduce energy exports; (6) which reduces hard currency earnings; (7) which reduces imports of technology from the West; (8) which reduces the GNP growth rates and forces the Soviets to choose between defense and consumers; (9) which means they must cut defense expenditures since to cut consumption would carry unacceptable political risks. I have shortened the chain in the interest of brevity, yet even this simple nine-step chain illustrates just how complicated and fragile the reasoning typically is in identifying political benefits from economic embargoes. For this particular chain there are so many unexplored alternatives along the way that the probability on making it to step nine is very low indeed.

My second point regards the different distribution of the cost and benefits of an embargo. The costs are highly concentrated in a few firms, and fall on a few individuals. In the case of the Reagan oil and gas technology embargo most of the costs were incurred by a few firms—GE, Dresser, Caterpillar—and their workers; for most U.S. citizens the cost of the embargo was virtually nil (except possibly the eventual indirect costs these firms pass on to their customers). But the benefits, if any, accrue to all U.S. citizens (and for that matter to citizens of Europe and Japan) as several U.S. foreign policy goals are realized. Very few people benefit significantly (it depends on how highly they value the changes in foreign policy of the country responding to the embargo); in other words the benefits, if any, are diffused throughout society. In this sense an embargo is like a tax for defense (or other public goods), with the rather unfair twist that a few citizens pay the entire tax, while the rest of us get a free ride.

Third, the costs of an embargo may linger far beyond when the benefits dissipate. The purposeful disruption of international commerce through an embargo induces the country which is the target of the embargo to form long-term relationships with suppliers in third countries, and thus impose long-term losses on the country imposing the embargo. The United States is experiencing this now as the Soviets seek to obtain as much grain as possible from other countries, and presumably the same will occur with oil and gas technology. It is only in those products where the country initiating the embargo has a definite and sustainable monopoly, and where the country which is the target of the embargo has a highly inelastic demand for those products, that the removal of an embargo will also remove the costs of the embargo. There are very few products in that category, therefore it is quite likely that the costs of an embargo will extend well beyond the point when the embargo is lifted.

The benefits, if any, will most likely dissipate somewhat more quickly. An embargo which succeeds in forcing the leaders of a country to change a policy against their wishes galvanizes those leaders to seek to take measures that insulate their economy from effects of the embargo (develop new technologies, new supply relationships, and so on), and as they do that they regain their freedom to set policies more to their liking. For all but the poorest of countries their options are such that any benefits which might result from an embargo will be rather short-lived.

Finally it is important to note that in an economically interdependent world embargoes are like poorly guided missiles with multiple warheads. One "warhead" may hit the country which is the target of the embargo, but other warheads are likely to hit innocent bystanders in the process. The oil and gas technology embargo is a good case in point where the December 29 measures relating to exports of U.S.-origin equipment already made it impossible for several European firms to meet their commitments to the Soviet Union for shipping turbines (because the GE-produced rotors would no longer be available).

In virtually all cases the economic costs of embargoes cannot be "contained" within the borders of the country imposing the embargo, which means that there are international political costs to imposing an embargo.

(III) This very brief discussion of the lessons from our recent experience with embargoes suggests several conclusions. If the United States Government once again contemplates using an embargo for the purposes of attaining foreign policy goals, then the potential benefits should be quite clearly spelled out, and should be very large because the probability they will occur will be quite low. Second, the firms and individuals who incur costs because of the embargo should be compensated; it is unfair to randomly tax a few individuals in support of a policy whose benefits are diffused throughout society. Third, the costs and benefits of an embargo must be computed for some time in the future in order to account for the fact that costs may linger for a long time. Finally, the costs to third countries should be estimated, and their political impact should be part of the calculus involved in deciding whether or not to use the embargo in the particular case under consideration.

I suspect that if these four factors are given careful consideration an embargo would rarely pass muster as a foreign policy tool. The potential benefits are usually small and virtually always uncertain. One case which might be an exception is where an embargo is the only tool available to protest a particularly distasteful policy of another government. Here a high value is being placed on symbolism. The United States as a great world power is rarely in such a single-option situation, but it is conceivable. Otherwise. diplomatic means seem relatively more promising. However, I would stress that in general it is very difficult for one nation to coerce another to change its policies on any but the most trivial of matters.

Moderator **HARDT**. Thank you very much, Ed.

There is, as many of you know, a continuity between the presentations of some of the discussions in the morning and this afternoon and also the forthcoming discussions tomorrow.

On the cost and benefit question, dealt with by Ed Hewett, many of them were identified and elaborated on in terms of indirect costs this morning; that is, business costs in a global sense, special legal problems, et cetera. So the identification of the costs and benefits as we go through the workshop with this common thread will be cumulative and we will try to keep track of the various cost and benefit elements and pull them together at the end.

The approaches in terms of the benefits and costs will be approached tomorrow by Charles Wolf and William Reichert in a somewhat different way and these also give another dimension to this cost-benefit approach.

It is extremely important to include as an active element of the discussion the question of the Soviet Union or the East European economies as that is our area of interest.

So to take a look at the role of Western trade in the Soviet economy we will ask Jan Vanous who is a senior economist at the centrally planned economies projects of the Wharton Econometric Forecasting Associates to initiate his discussion. He has had an extensive academic career subsequent to his completing his formal training, with his Ph. D. in economics from Yale University. His comments will summarize those in his prepared statement.

STATEMENT OF JAN VANOUS, SENIOR ECONOMIST, WHARTON ECONOMETRIC FORECASTING ASSOCIATES, INC., WASHINGTON, D.C.

SOVIET PARTICIPATION IN WESTERN TRADE AND ITS IMPACT ON THE DOMESTIC ECONOMY

Mr. **VANOUS**. I would like to address the question of what really is the role of trade with the West in the Soviet economy. I would like to look at both sides of the issue because somehow I have a feeling that what we are mostly concentrating on is the issue of the importance of imports from the West for the Soviet economy, but we should also ask what is the importance of exports. Especially since if we are going to talk about Western commercial policy vis-a-vis the Soviet Union obviously the West has also some leverage in influencing exports.

Before I begin, just to make a general statement so that we know what kind of magnitudes we are talking about, it is important to state that the Soviet Union is a relatively closed economy. By that

I mean that the scale of its participation in world trade relative to its size, be it population or GNP, is undoubtedly the smallest of all industrialized countries in the world. That is pretty important.

If you look at Soviet trade valued in world market prices, Soviet exports account, at least in my opinion, for something like 6 to 8 percent of Soviet GNP and imports somewhere between 4 to 6 percent of Soviet GNP. Why I stress valuation in world market prices is because the Soviet Union trades with different regions in different prices and if you want to make any kind of an international comparison, you have to standardize the prices and adjust for the very different prices that the Soviet Union uses in the bulk of its trade, namely trade with socialist countries.

If we concentrate on Soviet trade with the developed West alone, and have a look at, say, the year 1981, we see that Soviet exports to the developed West were about $24 billion and imports reached $25.2 billion. Relating it to a CIA estimate of Soviet GNP for 1981—that was close to $1.6 trillion and ignoring certain technical problems of relating trade flows to the estimate of GNP, we see that exports to the developed West accounted for about 1½ percent of Soviet GNP while imports accounted for almost 1.6 percent.

I am just giving this in relative terms. Obviously there are certain multipliers so that the importance of trade may be greater. I would also like to point out that the Soviet Union trades with the West also in an indirect sense through East European countries. To the degree that it buys anything from Eastern Europe or LDC's, the latter being less likely, that embodies Western technology or machinery or components, one could in some sense relate these purchases to trade with the West. So in a broader sense the Western trade share might be somewhat larger.

Nevertheless, to begin with, I think that in a global sense the Soviet economy is not critically dependent on trade with the West, although there might be some critical dependence in a microeconomic sense in some particular areas and these are fairly narrow.

Now I would like to look more systematically at Soviets exports and imports and analyze the main areas of sensitivity or vulnerability. I will start with exports.

The Soviet Union has a comparative advantage in the production of goods that are natural resource intensive: fuels, metals, minerals and other things with embodied natural resources. Its most important exports are fuels. In 1981, the last year for which we have actual data, the share of fuels exported to the developed West, or rather the share of fuels in total exports to the developed West was 78 percent, fully four-fifths of Soviet exports. The second most important item which is excluded from official trade statistics is gold, and last year we estimated sales were about $2.75 billion and this year the sales are likely to be something around $3 billion.

In comparison, exports of nonfood raw material—and these are minerals, lumber, diamonds, metals and so on—amount to about 17 percent of total exports. The remaining goods: Machinery, equipment, food and consumer goods account for about 5 percent of Soviet exports to the West.

Now, therefore, what we should concentrate on in terms of exports is how the West may perhaps be influencing Soviet energy exports. I see four areas of vulnerability or sensitivity in the Soviet case.

One, the Soviet Union is vulnerable to fluctuating energy prices and deteriorating terms of trade. It is clear that the days of steady increases in oil prices are over. The early 1980's are going to be a period of high instability in energy prices. Seventy percent of Soviet foreign exchange earnings comes from sales of energy, once we take into account the additional income from gold.

Now to the degree that you believe that the world energy markets are going to be unstable in the early 1980's, you can view the Soviet Union almost like a mono-cultural economy with respect to its exports. It is so dependent on energy that any major softening in the price of energy might have a major impact on the Soviet economy.

I think the vulnerability is also accentuated by the fact that the Soviet Union does not have a long-run capability to offset declining prices by stepping up the quantity of sales. The Soviet Union, that is, does not operate like Saudi Arabia, which, let's say, is currently producing at something like 40 percent capacity. The Soviet Union's, oil output, I believe, is at full capacity. There is some room for stepping up exports in the short run as the Soviets showed us in the first half of 1982 but not in the long run.

So therefore the Soviet Union is vulnerable to market forces. Now to the degree that the West could engineer further softening of oil prices by whatever means, the benefits are twofold. We can weaken OPEC and we can weaken the Soviet economy as well. So there is possibly a correlation here.

Second, there is a possibility of blocking Soviet energy sales for political reasons. This has been an argument that emerged within the Reagan administration recently when they tried to kill the Siberian pipeline on the grounds that it means more gas sales. This in turn means higher Soviet energy earnings, beefing up the Soviet economy, stepping up imports and increasing defense expenditures.

The problem is that the approach was rather naive because the Soviets aren't so stupid as to be sitting there and staking everything on gas exports. Quite to the contrary, the Soviet export policy with respect to energy, given the range of Soviet options, is quite brilliant I would say. So long as the energy prices do not collapse they cannot lose. They are very flexible in terms of substituting gas for oil in the long run.

Now should we deny them gas, I think that they will turn inwards, use the gas domestically, persuade Eastern Europe to take more and more gas and use the domestic savings of oil and the savings from oil from reduced sales to Eastern Europe to step up sales of oil in the West because oil is a nearly perfectly homogeneous commodity. There are uncontrolled markets like the Rotterdam spot market and there are alternative markets in developing countries and, I think, it is practically impossible to deny the Soviets the possibility of selling as much oil as they want.

By the way, I also don't believe that the Soviet sales of oil are necessarily closely correlated to domestic production because I think in the long run the Soviet objective is going to be to maintain a certain level of foreign exchange earnings. If they run into domestic production problems, they will probably slow down the growth of the domestic economy in order to maintain their export sales. They will still realize growth because an economy has really two options on how to increase its welfare. One is through growing internally and another way is through opening itself up to more trade or maintaining that trade. The Soviets will try to realize gains from trade rather than trying to increase or maintain domestic oil consumption.

The third area of vulnerability, I believe, is the refusal to buy Soviet gas at the prevailing world market price. This may sound farfetched, but there is that possibility in view of how badly the Soviets need hard currency. They want to sell gas for hard currency and there is only one market where they can sell it, and that is Western Europe. This possibility has been overlooked—what if Western Europe created a gas-purchasing cartel. There is a number of reasons why oil companies may not be interested in that and there is a number of reasons why some West European governments may not be interested in it as well because it has some important implications. But it is clear that because of the relatively low domestic Soviet production cost of gas and the rapidly rising cost of oil that the Soviets would be willing to sell the gas at a substantially lower price than the prevailing world market price.

In fact, a rational Soviet negotiator, when selling gas, should look at the global terms of trade and shouldn't be at all concerned about whether he gets a world market price or not. That is totally irrelevant. The only thing that is relevant is how much real goods you can exchange for a given amount of gas, and that is what the Soviets are concerned about. Fortunately for the Soviets, the West Europeans have not organized themselves for one reason or another. So the Soviets are not really that vulnerable.

The remaining area is the possibility of the West raising some tariff barriers and quantitative restrictions on Soviet exports, but this is generally more easily done in the area of manufactured goods and food where you can close certain markets and the Soviets simply don't sell anything in that area. So it is unlikely.

So, on the export side, I think, the main conclusion is that Soviet vulnerability is basically to the market forces. To the degree that market forces are now working in the direction in which the developed West desires, that is the softening of oil markets, there may be some weakening in the Soviet financial position and the West could exploit it perhaps in some positive direction.

Now looking at the sensitivity of the Soviet economy to imports from the developed West, if one looks at the statistics—and by the way in my paper I have provided an appendix with data of what the Soviet trade with the developed West is—the largest single group of commodities that the Soviets are importing from the developed West are nonfood raw materials. It is a very mixed category the way they define it. It includes chemicals, metals, minerals and a lot of steel products. Steel pipe, for example, is included in the raw material category. The second most important category is food and, finally, you get machinery. There are virtually no consumer goods of importance or fuels which are imported from the developed West.

So there are three commodity categories which we can look at. Of the three, at least in the short run, I am quite convinced, that the greatest sensitivity is in the area of food imports for maintenance of adequate domestic food supply. If, in the short run, say in a year of bad harvest, the Soviets were denied access to imported grain and imported food, it could cause major problems for them.

In fact, the vulnerability comes from the fact that they have to spend hard currency for food. Therefore, whenever there are bad results in the Soviet economy and we are willing to sell them food, grain, and related commodities for hard foreign exchange, this crowds out other Soviet potential import expenditures and therefore causes a hardship for the Soviet economy.

Well, in any given year, surely the Soviets would always wish to have a good harvest, but the reality is different and they know they cannot rely on good harvests and they also have made, in my opinion again, a conscious decision not to be realistic about their harvest outlooks. That is, they are intentionally not producing enough, so that on the average they have to import—meaning they have accepted the risk of bad weather and are willing to import.

Since they have been importing steadily for the past 11 years, it is clear that they have accepted the long-term risk of poor harvests and at times in fact the amounts of food they imported were rather staggering. The worst year in that sense was probably 1981 when Soviet food imports from all non-socialist countries together reached $13.7 billion and grain imports reached 43 million tons. In 1981, grain imports accounted for 20 percent of overall grain consumption and the share of imports from the developed West represented about 13 percent of this consumption.

I think the Soviets were unpleasantly surprised by what happened in 1981. On the other hand, I still don't see evidence that they are really interested in closing the gap in view of the very costly investment expenditures that they would have to incur. In my mind, there is a question of why the Soviets in fact aren't really importing even more food and exporting more energy because if you just used straightforward cost calculation, it seems there would be net gains to the Soviets from engaging in more trade of this type.

The next item of major importance I think is Western technology. What is the importance of Western technology for the Soviet economy? I think this is an area which is surrounded by more myths than anything else.

First of all, it is not true that most of the machinery imported by the Soviets from the West involves high technology items. From reading the newspapers sometimes you get the impression as if the Soviets were mostly importing computers and things like that, when in fact these things are on the COCOM list.

What they are importing from the West in many cases is fully standardized machinery which is available also from alternative suppliers. The reason why it is not purchased in Eastern Europe or from alternative suppliers or even produced domestically is that there are capacity constraints, and the quality of corresponding products from the domestic economy or through Eastern Europe is not that good. There are problems with delivery dates, availability of spare parts and servicing, and these are all major considerations for importing from the West.

Second, contrary to popular impression, these imports have been steadily falling in real terms in recent years. I will just state the figures since 1975, and I state them in 1975 prices so that they are comparable. These imports peaked at $5.7 billion in 1978 and since then have been steadily declining, $5.2 billion in 1979, $5 billion in 1980, and $4.6 billion in 1981. So, in real terms, for the past 4 years, Soviet imports of Western machinery have certainly been steadily declining.

Third, the Soviet Union imports more machinery from CMEA than it does from the developed West. I am being quite generous, but at the official exchange rate in 1981 the Soviet imports of machinery from Eastern Europe amounted to $15 billion. I think East European machinery is not as good as Western machinery. It is overpriced and I am willing to deflate that figure at some realistic rate to something around $8 billion. In comparison, imports from the West were $6.1 billion in 1981 implying that, if we ignore those marginal imports from Yugoslavia and some Asian CPE's, Western machinery accounted for about 44 percent of total Soviet machinery imports. I am discounting the East European machinery very heavily here to give the best possible advantage to the argument that the Soviet economy is dependent on machinery imports from the West.

Finally, the fourth issue is what is the share of these total machinery imports in total Soviet machinery used, and there we come to a conclusion that total Soviet machinery imports account for about 8 percent of Soviet machinery production, and this estimate is for 1981. But imports from the West alone would account for only about 3½ percent.

My conclusion is that in a global sense the Soviet economy is not dependent on imports of machinery from the West, although of course there are some narrow areas where the share of Western machinery may be as high as 50 percent or even more. That is, the more microeconomic you become in your outlook or the closer you go to identifying certain subbranches of industries, the more likely it is that you can find an industry where the share is very high, for example, in the case of chemical fertilizer plants. If you define an industry that narrowly, you can find that the share of imported capital is quite high.

As far as the importance of imported nonfood raw materials in the total aggregate supply of intermediate goods is concerned, probably the most important group of imports are imports of steel pipes and some steel products. But again, this is not an example of something that the Soviets are importing because they are not capable of producing it domestically. If they really put their mind to it, they could do it or steer Eastern Europe into producing it. I think the issue is mostly that their demand is so huge. They simply don't have the capacity and it is a sensible economic decision to import it. Should they find out that in the future the pipes will not be available, presumably in the long run they would be capable of developing the capacity to produce it themselves.

In conclusion, in the import area, I feel that the largest potential vulnerability to the Soviets is from denial of food imports. However, for practical reasons, actual vulnerability to a grain embargo is not that large. We have the lesson of Afghanistan. We know how efficiently grain markets work. We know that there are new alternative sources of supply and if we rule out some kind of an unprecedented aggressive act on the part of the Soviet Union, it is difficult to visualize that major Western suppliers would agree to a grain embargo. And, even then, I think it would be nearly impossible to obtain the cooperation of several alternative suppliers from developing countries such as Argentina, Brazil, Thailand, and so on.

Otherwise, with regard to dependence of the Soviet economy on machinery imports from the West, I think that the global direct and indirect independence is relatively low and the Western leverage is limited.

I would like to stress that the sophisticated Western technology that we are concerned about with potential military applications is generally not obtained through the usual commercial channels, but it is stolen, purchased clandestinely or copied. The Soviets aren't buying this kind of gear through regular commercial deals.

So to deny them access to that type of sensitive technology is not an issue of trade. This is an issue of security. Most of the standardized machinery can be replaced, in my opinion, with domestic machinery or East European imports. All it may take is to use twice as much or three times as much of substitute machinery. Of course, this strategy is not efficient and will impose some cost on the Soviet economy, but it will not bring the Soviet economy down or cause a major disruption in the long run.

[Mr. Vanous' prepared statement follows:]

PREPARED STATEMENT OF DR. JAN VANOUS

I. INTRODUCTION

The Soviet economy is a relatively closed economy, i.e., the scale of its participation in world trade relative to its size is undoubtedly the smallest of all industrialized countries in the world. Valued in world market prices, total Soviet exports account for 6-8 percent of Soviet GNP and imports account for 4-6 percent of Soviet GNP. (A range of estimates is given because of uncertainties in the valuation of trade with different regions of the world and in view of the uncertainty surrounding the dollar estimate of Soviet GNP. The higher share of exports in GNP than imports reflects the large surplus—or implicit trade subsidy—in Soviet trade with Eastern Europe which is apparent once this trade is valued at comparable world market prices and in dollars.)

Most of Soviet exports are destined for socialist countries (Eastern Europe, Yugoslavia, Asian socialist countries, and Cuba). For example, in 1980, exports to the developed West accounted for only 29 percent of the total quantity of goods (with individual commodities valued at world market prices) exported by the Soviet Union to all regions of the world. However, in terms of actual export revenues earned, exports to the developed West accounted for 42 percent of total export revenue. (The difference between these two values is a reflection of a more realistic valuation of the ruble at $0.85 for 1980 instead of its official inflated value of $1.54. When ruble export receipts are re-valued more realistically using the former conversion rate, the dollar value of ruble exports to socialist countries declines sharply and the relative importance of hard-currency earnings in the developed West rises.) On the other hand, imports from the developed West accounted for 43 percent of the total quantity of goods imported by the Soviet Union in 1980 and 46 percent of total import outlays.

If we concentrate on Soviet trade with the developed West alone, we find that in 1981 Soviet exports to this region amounted to $24 billion while imports reached $25.2 billion. According to CIA estimates, Soviet GNP in 1981 reached $1,587 billion. Ignoring certain technical problems of the CIA estimate of Soviet GNP in dollars, this means that in 1981 exports to the developed West accounted for 1.5 percent of Soviet GNP while imports accounted for almost 1.6 percent. There is little doubt that in the aggregate sense the dependence of the Soviet economy on trade with the developed West is relatively low.

The fact that the aggregate dependence of the Soviet economy on East-West trade is low does not mean that there are not any areas where Western leverage may indeed be significant. One important point is that a significant portion of Soviet trade with Eastern Europe (particularly trade in machinery) has Western components and technology embodied in the products traded. Thus in a broader sense, the Soviet dependence on the West is significantly greater than that implied by the fact that direct imports from the developed West account only for 1.6 percent of Soviet GNP. What is even more important, there are some areas in which the Soviet economy is critically dependent on trade with the West in a microeconomic sense. In order to understand the impact of Western trade on the Soviet economy, it is useful to analyze the commodity composition of Soviet trade with the developed West. This analysis is provided below.

II. SENSITIVITY OF SOVIET EXPORTS TO WORLD MARKET DEVELOPMENTS AND WESTERN TRADE POLICIES

The Soviet Union has a comparative advantage in the production of fuels (oil and gas), metals, minerals, and other natural resources. Relatively low domestic production costs and rising prices of energy on the world market have led the Soviet Union to rely increasingly on exports of fuels as a source of export revenue in the developed West. Whereas in 1970 sales of fuels accounted for less than 30 percent of total Soviet export revenue in the developed West, by 1975 their share had risen to almost 56 percent, in 1980 it amounted to 72 percent and last year it reached a record of close to 78 percent. The second most important export item to the developed West, which is not included in Soviet trade statistics, is gold. In 1981, Soviet gold sales were estimated at 252 metric tons valued at $2.75 billion and this year the gold export revenue is expected to be around $3 billion. Exports of all non-food raw materials combined were about $4.1 billion in 1981 or 17 percent of total exports. Exports of the remaining commodities—machinery and equipment, food and raw materials for food, and industrial consumer goods—represented a mere 5 percent of total Soviet exports to the developed West in 1981.

Given the commodity structure of its exports to the developed West, the Soviet Union is vulnerable to the following factors affecting its exports:

Fluctuating energy prices and deteriorating terms of trade.—In the case of the Soviet Union, this vulnerability is like that of a monocultural economy. Almost 70 percent of the country's foreign exchange earnings come from sales of energy and an additional 10 percent come from sales of gold—a commodity which is likely to move in the same direction as oil in any major price swing. To the degree that we accept the proposition that in the first half of the 1980's oil prices may be very unstable and possibly move sharply in the downward direction, if not in nominal than at least in real or relative terms, Soviet export earnings are rather vulnerable. The vulnerability is accentuated by the fact that the Soviet Union does not have a long-run capability to compensate for weakening of export prices by stepping up the quantity of exports because of lack of adequate domestic supply—Soviet domestic demand and East European import requirements are rapidly catching up with increasingly stagnant Soviet production capabilities.

Blockage of Soviet energy sales for political reasons.—The Reagan Administration appears to have had this strategy in mind when it tried to kill the West Siberian gas export pipeline deal with Western Europe. However, Soviet vulnerability to the denial of an export market for gas is quite limited in the long run. The Soviet Union has an option to use more gas domestically and sell more gas to Eastern Europe and in turn use the domestic oil savings and oil savings from reduced exports to Eastern Europe to step up sales of oil in the West. Because oil is nearly a perfectly homogeneous commodity, and in view of the presence of uncontrolled markets (Rotterdam spot market) and alternative markets (developing countries), it is practically impossible to prevent the Soviet Union from selling as much oil as it wishes.

Refusal to buy Soviet gas at prevailing "world market price."—Because of the need for hard-currency and lack of alternative hard-currency markets, the Soviet Union must look to Western Europe as the only potential market for additional gas sales. Given the low Soviet production and transmission cost and high scarcity value of convertible currency in the Soviet Union, the Soviets are vulnerable to the creation of a West European gas purchasing cartel, which would insist on buying Soviet gas at a price well below the prevailing "world market price," yet high enough to make the deal still profitable to the Soviets. A recent Wharton Current Analysis (October

27, 1982) has shown that the Soviet Union could probably be forced to sell its gas to Western Europe at least 25 percent below the present price and the discount is likely to increase as the domestic Soviet extraction cost of the only major alternative export—crude oil—continues to rise rapidly. However, the inability of West European governments or major gas companies (which would require governmental permission to form a gas purchasing cartel) to join forces in dealing with the Soviets makes this "threat" relatively weak.

Tariff barriers and quantitative restrictions on Soviet exports.—Given the small share of manufactured goods and food in Soviet exports, these barriers to Soviet exports are of virtually no significance.

Clearly, on the export side, Soviet vulnerability is mostly limited to market forces, i.e., movements in world market prices of energy and gold. This vulnerability has been apparent for the past two years. In 1981, average Soviet oil export prices to the developed West increased about 12 percent but with the decline in the quantity of oil and oil products sold by at least 6 percent, total Soviet energy export revenue in the developed West increased less than 6 percent. During the first half of 1982, total Soviet exports to the developed West increased 22 percent; given the 5-10 percent decline in average oil export prices, the quantity of Soviet energy exports to the developed West must have increased by about one-third. However, such a pace of oil sales could not be maintained and it now appears that total Soviet exports to the developed West in the second half of 1982 will now be only slightly over $10 billion compared to $12.6 billion in the first half of 1982. With the now widely predicted delay in Western economic recovery until the last quarter of 1983/first quarter of 1984 and given the deteriorating financial situation of a number of oil exporting countries (Mexico, Nigeria, Libya, Iraq, etc.)—and hence the increased pressure to step up production and sales—the downward pressure on oil prices in 1983 is likely to continue. Under an optimistic forecast, average OPEC oil prices will not fall in 1983 below the 1982 average estimated at $33.15 per barrel. In any case, when price changes and exchange rate fluctuations are taken into account, the value of a barrel of oil will decline at least 5-8 percent in real terms next year. However, more pessimistic forecasts—which under the present circumstances should be taken with increasing seriousness—imply much greater declines in world energy prices. We now cannot rule out a major decline in Soviet earnings from energy exports to the developed West in 1983 at a time when Soviet import needs are rising and the possibility of sharply increased borrowing is not feasible for political reasons.

III. SENSITIVITY OF SOVIET ECONOMY TO IMPORTS FROM THE DEVELOPED WEST

If we look at the commodity composition of Soviet imports from the developed West, we find that in 1981 the largest share of total imports was accounted for by imports of non-food raw materials (including semimanufactures and certain manufactured products such as steel pipe)—39 percent, followed by food and raw materials for food—28 percent, and machinery and equipment—24 percent. Imports of fuels and industrial consumer goods other than food were relatively very small and together accounted for only 9 percent of total Soviet imports from the developed West.

With respect to the sensitivity of the Soviet economy to these imports, our ranking of their relative importance (in descending order) would be as follows:

Importance of food imports for maintenance of adequate domestic food supply.—Empirical evidence points to the fact that whenever there is a poor harvest in the Soviet Union, imports of grain and other food are stepped up. Ceteris paribus, increased import outlays for food tend to crowd out imports of machinery and equipment and imports of non-food raw materials. However, since the Soviet Union has distinct comparative disadvantage in grain and food production for soil quality, climatic, and above all a host of systemic reasons, it is to its advantage to rely on substantial long-term imports of food from the West. As we pointed out in our Current Analysis of September 10, 1982, the world market tradeoff between oil and grain is far more favorable than the corresponding domestic resources tradeoff in the Soviet Union. In particular, imports of an extra 1 million metric tons of grain this year save resources equivalent to about 2.8 million metric tons of oil, which would be valued at $700 million on the world market. The saving in terms of natural gas is far greater and was estimated to approach 12.7 million metric tons oil equivalent of natural gas, which would be valued at about $2.3 billion on the world market. In comparison, 1 million metric tons of wheat has a current world market value of about $160 million. (The saving comes from the willingness of the Soviet political leadership to import grain whenever necessary instead of striving for increased domestic production and self-sufficiency irrespective of its domestic resource cost.)

In 1981, Soviet imports of grain and other food from non-socialist countries reached a record level of $13.7 billion, of which $7.6 billion were imports of grain and flour and $6.1 billion were imports of other food. Food imports from the developed West amounted to $7.2 billion ($5.2 billion worth of grain and flour and $2 billion worth of other food). Total grain imports from all countries reached 43 million metric tons and about 65 percent of that amount came from the developed West. Imports of 43 million metric tons of grain represent approximately 20 percent of apparent Soviet grain consumption in 1981 and thus the share of imports from the developed West represented about 13 percent of this consumption. If we assume for simplicity that the Soviet Union trades oil for grain, by importing grain from the developed West instead of producing it domestically, the Soviet Union saved resources equivalent in value to roughly $20 billion (or about 80 million metric tons of oil).

The availability of grain imports enables the Soviet Union to eliminate costly expenditures on fertilizer, agricultural machinery, grain drying facilities, storage facilities, etc. It also permits the Soviet political leadership to avoid undertaking major institutional and incentive reforms in agriculture with their inevitable political repercussions. The resources saved by importing grain can be allocated for other purposes (personal consumption, investment in non-agricultural projects, defense, etc.). In fact, the only reason why the Soviets probably do not specialize even more in energy production and import more food in exchange for exports of energy is for political and strategic reasons (in the short run there is also a capital constraint). Perhaps a 20 percent share of imported grain is the maximum tolerable from a security viewpoint.

Importance of Western technology for the Soviet economy.—This is an area surrounded by more myths than any other. First of all, it is not true that most Soviet machinery imports from the West are high technology items. In fact, most of the machinery imported from the West is fairly standardized and available also from East European suppliers. The reason why the Soviet Union imports machinery from the West is in many cases not the inability to produce something similar at home or buy it in Eastern Europe, rather it is the capacity constraints, product quality, delivery dates, availability of spare parts and servicing which are major considerations for importing from the West.

Second, contrary to popular impression, these imports have been falling steadily in real terms in recent years. In 1975, these imports reached $5.0 billion and in terms of 1975 prices, they were at the following levels in subsequent years: $5.5 billion in 1976, $5.6 billion in 1977, $5.7 billion in 1978, $5.2 billion in 1979, $5 billion in 1980, and $4.6 billion in 1981. Thus, real Soviet imports of Western machinery and equipment have been declining steadily since they reached their peak in 1978.

Third, the Soviet Union imports less machinery from the developed West than it does from Eastern Europe. Machinery imports (excluding arms) from six CMEA countries (Bulgaria, Czechoslovakia, East Germany, Hungary, Poland, and Romania) in 1981 amounted to $15 billion at the official exchange rate of $1.39 per ruble and $7.9 billion when we revalue these imports at prevailing world market prices (the corresponding conversion rate is only $0.73 per ruble). If we ignore marginal imports of machinery and equipment from Yugoslavia, Asian CPEs, and a few developing countries, we can see that the developed West accounted for only about 44 percent of total Soviet machinery imports (in 1981 their nominal value was $6.1 billion).

Fourth, when related to intermediate and final demand for machinery in the Soviet economy, the share of imported machinery is relatively low. Our preliminary estimate of 1981 gross output of machinery in the Soviet Union is 180 billion rubles. A recent estimate of the actual dollar value of one ruble worth of Soviet machinery was $2 per ruble. This estimate did not, however, account for quality differences between Soviet and Western machinery. If we discount for the quality differences, a conversion rate of $1 per ruble may be more appropriate. At the latter rate, $15 billion worth of imported machinery would represent about 8 percent of total machinery production. Imports from the West alone would then account for only about 3.5 percent. While the dependence in particular areas of machinery use is bound to be far higher, it is clear that in an aggregate sense, the dependence of Soviet economy on machinery imports from the West is relatively low. (It should be noted that if we take into account the Western components and technology embodied in East European machinery exports to the Soviet Union, the direct and indirect dependence of the Soviet economy on machinery imports from the West may rise by another 1-1.5 percent. However, even 5 percent dependence cannot be viewed as significant in a global sense.)

Importance of non-food raw materials imported from the West in aggregate supply of intermediate goods.—Since 1970, Soviet imports of non-food raw materials (including semimanufactures and certain manufactured products such as steel pipes and other steel products) have been consistently the largest category of imports in terms of their dollar value. This group of imports is highly varied in its composition and includes metals, minerals, chemicals, steel products, construction materials, and non-food raw materials of agricultural origin. In terms of their volume, imports of steel pipe are of greatest importance. (Naturally, in a microeconomic sense, there may be certain strategic metals and chemicals which are crucial for production in some sectors and for which no domestic substitutes are available.) Steel pipe is again an example of something imported from the West primarily because Soviet needs are so large that their domestic production capacity cannot meet the demand. The Soviets are capable of producing similar pipe but not in adequate quantity—hence the Soviet vulnerability is more of short-term rather than long-term nature.

The conclusion from analyzing the commodity composition of Soviet imports is that the main area of potential vulnerability in the short run is to a grain/food embargo. However, actual Soviet vulnerability to a grain embargo is not that large unless the embargo is worldwide. Barring unprecedented aggressive act on the part of the Soviet Union, it would be very difficult to unify major Western suppliers (United States, Canada, Australia, France, and several re-exporting countries in Western Europe) to agree to a grain embargo. It would be nearly impossible to obtain cooperation of several developing countries (Argentina, Brazil, Thailand, etc.). Thus the actual vulnerability—in contrast to potential vulnerability—is much smaller.

With regard to the dependence of the Soviet economy on machinery imports from the West, the global direct and indirect dependence is relatively low. Even if the West simultaneously restricted the flow of technology to Eastern Europe, a major reduction in Western machinery exports to the Soviet Union would still be unlikely to have a significant effect on its economic performance. The sophisticated Western technology with potential military applications is in general not obtained through the usual commercial channels, but stolen, purchased clandestinely, or copied. The standardized Western machinery, which represents the bulk of Soviet machinery imports from the developed West, can be replaced with domestic machinery or East European imports. (It should be noted that Soviet imports of machinery from Eastern Europe are currently rising rapidly due to the deterioration in East European terms of trade with the Soviet Union and Soviet insistence on balancing its bilateral trade with Eastern Europe.) Thus most of imported Western machinery can be replaced with larger amounts of domestic or imported East European substitutes. While this solution is more costly and inefficient, it would work to plug the gap should Western machinery become unavailable.

Finally, a reduction or a slowdown in Western exports of certain raw materials and semimanufactures would in most cases prove to be no more than an irritant to the Soviets, causing temporary supply bottlenecks and slowdown in growth of output in some areas. However, in the longer run, the Soviets could take steps to eliminate the bottlenecks and negate the impact of Western trade restrictions.

SOVIET EXPORTS TO MDCS—DEVELOPED WEST

[In millions of current dollars]

	Total	Machinery	Fuels	Raw materials	Food	Consumer goods
	TETUMD	TE1UMD	TE2UMD	TE3UMD	TE4UMD	TE5UMD
1950	262.1	6.7	10.0	150.5	88.9	6.0
1951	339.7	5.7	23.5	154.1	152.8	3.6
1952	385.2	5.9	35.4	112.2	229.8	1.9
1953	386.2	9.7	50.3	181.1	143.2	1.9
1954	473.7	9.9	87.3	288.8	85.3	2.4
1955	558.3	16.2	82.1	381.3	75.9	2.8
1956	614.3	16.2	112.8	405.1	76.7	3.5
1957	714.1	16.8	162.8	432.3	97.9	4.3
1958	702.4	11.7	159.9	434.7	91.4	4.7
1959	887.9	17.7	233.2	493.5	137.4	6.1
1960	1,014.8	21.1	269.0	593.8	122.8	8.1
1961	1,093.4	24.1	300.7	599.5	160.7	8.4
1962	1,137.0	32.7	340.7	616.7	136.9	10.0

SOVIET EXPORTS TO MDCS—DEVELOPED WEST—Continued

[In millions of current dollars]

	Total	Machinery	Fuels	Raw materials	Food	Consumer goods
	TETUMD	TE1UMD	TE2UMD	TE3UMD	TE4UMD	TE5UMD
1963	1,261.1	51.2	406.8	631.1	158.3	13.7
1964	1,312.0	50.4	422.5	740.0	77.2	21.9
1965	1,495.6	58.8	413.3	884.4	112.2	26.9
1966	1,756.4	77.7	484.2	1,032.9	130.0	31.6
1967	1,934.1	68.5	579.4	1,049.4	190.5	46.3
1968	2,096.8	65.5	640.8	1,145.0	192.2	53.3
1969	2,284.3	79.1	637.9	1,241.2	263.6	62.5
1970	2,393.4	104.1	706.4	1,324.9	179.0	79.0
1971	2,758.1	96.1	984.3	1,349.6	235.7	92.4
1972	2,944.3	118.8	962.9	1,577.5	161.0	124.1
1973	5,093.1	218.6	1,849.2	2,475.8	347.3	202.2
1974	8,268.6	240.7	3,857.5	3,338.6	604.9	226.9
1975	8,511.3	384.3	4,737.1	2,784.1	312.4	293.3
1976	10,391.8	425.5	6,326.5	3,075.1	245.2	319.5
1977	11,965.9	374.2	7,466.1	3,494.3	229.0	402.3
1978	12,731.9	451.0	8,142.5	3,289.5	224.1	624.8
1979	19,081.8	590.5	13,088.0	4,643.9	287.1	472.3
1980	24,436.4	499.4	17,672.4	5,236.8	285.3	742.5
1981 [1]	23,994.0	625.0	18,670.0	4,138.0	210.0	351.0

[1] Preliminary estimate.

SOVIET IMPORTS FROM MDCS—DEVELOPED WEST

[In millions of current dollars]

	Total	Machinery	Fuels	Raw materials	Food	Consumer goods
	TMTUMD	TM1UMD	TM2UMD	TM3UMD	TM4UMD	TM5UMD
1950	227.0	99.0	7.3	105.7	12.3	2.7
1951	301.2	97.5	0.0	171.6	26.6	5.5
1952	430.9	108.7	3.4	265.9	40.7	12.2
1953	444.2	111.7	0.7	238.1	81.0	12.7
1954	586.2	167.6	0.0	274.7	122.6	21.3
1955	446.4	181.2	11.2	175.0	72.3	6.7
1956	600.3	229.1	26.0	265.0	68.4	11.8
1957	698.2	217.1	21.3	345.8	98.9	15.1
1958	657.0	194.1	19.0	350.8	77.6	15.5
1959	788.2	294.1	19.5	395.0	58.6	21.0
1960	1,115.5	458.2	19.1	568.8	44.2	25.2
1961	1,117.3	474.9	15.5	531.9	67.2	27.8
1962	1,305.6	601.8	12.1	603.1	59.8	28.8
1963	1,423.6	588.8	15.9	547.4	239.8	31.7
1964	1,763.7	621.0	4.7	454.9	643.0	40.1
1965	1,632.8	510.3	4.9	589.8	454.3	73.5
1966	1,778.4	561.0	5.3	609.2	476.6	126.3
1967	1,815.2	670.0	5.5	708.3	200.2	231.2
1968	2,182.9	897.4	5.4	805.9	180.4	293.8
1969	2,528.3	1,119.7	6.4	996.8	98.6	306.8
1970	2,822.3	1,104.1	7.8	1,154.0	229.0	327.4
1971	2,889.9	1,032.5	9.5	1,256.8	280.2	310.9
1972	4,150.2	1,355.3	8.4	1,455.7	1,006.1	324.8
1973	6,232.8	1,933.7	14.7	2,194.9	1,800.0	289.5
1974	8,115.3	2,542.5	22.0	4,236.2	889.7	424.9
1975	13,451.7	4,976.7	43.9	5,270.6	2,514.2	646.4
1976	14,776.1	5,803.9	60.5	5,182.3	3,085.4	644.1
1977	14,354.0	6,163.9	55.9	5,338.0	2,177.5	618.6
1978	16,349.2	7,033.9	76.9	6,031.6	2,677.2	529.6
1979	20,242.7	6,867.4	362.5	7,603.3	4,679.2	730.3

SOVIET IMPORTS FROM MDCS—DEVELOPED WEST—Continued

[In millions of current dollars]

	Total	Machinery	Fuels	Raw materials	Food	Consumer goods
	TMTUMD	TM1UMD	TM2UMD	TM3UMD	TM4UMD	TM5UMD
1980	24,238.3	7,085.6	286.3	10,024.3	5,615.0	1,227.1
1981 [1]	25,197.0	6,060.0	589.0	9,715.0	7,153.0	1,680.0

[1] Preliminary estimate.

SOVIET BALANCE OF TRADE WITH MDCS—DEVELOPED WEST

[In millions of current dollars]

	Total	Primary goods	Manufactures	Machinery	Fuels	Raw materials	Food	Consumer goods
	TBTUMD	TBPUMD	TBMUMD	TB1UMD	TB2UMD	TB3UMD	TB4UMD	TB5UMD
1950	35.1	124.1	−89.0	−92.3	2.7	44.8	76.6	3.3
1951	38.5	132.2	−93.7	−91.8	23.5	−17.5	126.2	−1.9
1952	−45.7	67.4	−113.1	−102.8	32.0	−153.7	189.1	−10.3
1953	−58.0	54.8	−112.8	−102.0	49.6	−57.0	62.2	−10.8
1954	−112.5	64.1	−176.6	−157.7	87.3	14.1	−37.3	−18.9
1955	111.9	280.8	−168.9	−165.0	70.9	206.3	3.6	−3.9
1956	14.0	235.2	−221.2	−212.9	86.8	140.1	8.3	−8.3
1957	15.9	227.0	−211.1	−200.3	141.5	86.5	−1.0	−10.8
1958	45.4	238.6	−193.2	−182.4	140.9	83.9	13.8	−10.8
1959	99.7	391.0	−291.3	−276.4	213.7	98.5	78.8	−14.9
1960	−100.7	353.5	−454.2	−437.1	249.9	25.0	78.6	−17.1
1961	−23.9	446.3	−470.2	−450.8	285.2	67.6	93.5	−19.4
1962	−168.6	419.3	−587.9	−569.1	328.6	13.6	77.1	−18.8
1963	−162.5	393.1	−555.6	−537.6	390.9	83.7	−81.5	−18.0
1964	−451.7	137.1	−588.8	−570.6	417.8	285.1	−565.8	−18.2
1965	−137.2	360.9	−498.1	−451.5	408.4	294.6	−342.1	−46.6
1966	−22.0	556.0	−578.0	−483.3	478.9	423.7	−346.6	−94.7
1967	118.9	905.3	−786.4	−601.5	573.9	341.1	−9.7	−184.9
1968	−86.1	986.3	−1,072.4	−831.9	635.4	339.1	11.8	−240.5
1969	−244.0	1,040.9	−1,284.9	−1,040.6	631.5	244.4	165.0	−244.3
1970	−428.9	819.5	−1,248.4	−1,000.0	698.6	170.9	−50.0	−248.4
1971	−131.8	1,023.1	−1,154.9	−936.4	974.8	92.8	−44.5	−218.5
1972	−1,206.0	231.2	−1,437.2	−1,236.5	954.6	121.8	−845.1	−200.7
1973	−1,139.6	662.8	−1,802.4	−1,715.1	1,834.6	280.9	−1,452.7	−87.3
1974	153.3	2,653.1	−2,499.8	−2,301.8	3,835.5	−897.6	−284.8	−198.0
1975	−4,940.5	5.0	−4,945.5	−4,592.4	4,693.2	−2,486.5	−2,201.8	−353.1
1976	−4,384.3	1,318.7	−5,703.0	−5,378.4	6,266.0	−2,107.2	−2,840.2	−324.6
1977	−2,388.1	3,617.9	−6,006.0	−5,789.7	7,410.1	−1,843.7	−1,948.5	−216.3
1978	−3,617.3	2,870.4	−6,487.7	−6,582.9	8,065.6	−2,742.1	−2,453.1	95.2
1979	−1,160.9	5,374.0	−6,534.9	−6,276.9	12,725.5	−2,959.4	−4,392.1	−258.0
1980	198.1	7,268.9	−7,070.8	−6,586.2	17,386.1	−4,787.5	−5,329.7	−484.6
1981 [1]	−1,203.0	5,561.0	−6,764.0	−5,435.0	18,081.0	−5,577.0	−6,943.0	−1,329.0

[1] Preliminary estimate.

[From the Wharton Econometric Forecasting Associates, July 14, 1982]

DEPENDENCE OF SOVIET ECONOMY ON FOREIGN TRADE

On July 12 the Bureau of the Census released a study of dependence of the Soviet economy on foreign trade prepared by the Census Bureau's Barry L. Kostinsky and Vladimir G. Treml of Duke University. The purpose of the study was to estimate the value of Soviet exports and imports in domestic Soviet prices instead of the actual transaction prices that prevail in foreign trade (world market prices for most of the trade with the developed West and developing countries, special intra-CMEA prices for trade with Eastern Europe, and mix of the first two sets of prices for trade with other socialist countries).

The two main results of the Kostinsky-Treml study pertaining to year 1980 are:

Soviet exports valued at domestic Soviet prices amounted to about 32 billion domestic rubles or 7 percent of Soviet national income (net material product).

Soviet imports valued at domestic Soviet prices amounted to about 92 billion domestic rubles or 20 percent of Soviet national income.

Commenting on the results of the study, the Census director Bruce Chapman said: "The new analysis shows that the Soviet Union is more open to the influences of international market forces than many people have believed. That, in turn, suggests greater Soviet vulnerability to economic sanctions than has been understood up to now." The press, such as the New York Times, tended to interpret the findings as supportive of the view of the Defense Secretary Weinberger, who has maintained that the sanctions would prove effective in denying the Soviet Union a source of hard currency, from the sale of gas, that could be used for armaments.

The problem with the above interpretations of the Kostinsky-Treml study is that they imply that the correct measure of the dependence of the Soviet economy on foreign trade is the ratio of exports or imports measured in domestic prices to national income measured in domestic prices. We believe that this is not so and that, in fact, out of the three possible measures, the above measure is the poorest.

There are three possible simple aggregate measures of a country's foreign trade dependence:

The ratio of exports or imports (or the two combined) measured at domestic scarcity (shadow) prices to national income measured at identical scarcity prices.

The ratio of exports or imports measured at comparable world market prices to national income measured at the same comparable world market prices.

The ratio of exports or imports measured at internal domestic prices to national income measured at the same internal domestic prices.

Economists would generally prefer the first measure in all situations in which either domestic or international prices are known to be distorted. Unfortunately, domestic scarcity (shadow) prices for the Soviet economy are generally not available to Western researchers and even their estimates in the Soviet Union obtained from solutions of large-scale linear programming models of the Soviet economy must be highly tentative.

The third measure is of considerable interest if one believes that the Soviet planners actually behave as if their domestic prices, which are known to be seriously distorted and in many cases quite arbitrary, were scarcity prices conveying correct information about opportunity costs within the Soviet economy. In short, if the Soviet leaders believe that 20 percent of their national income is accounted for by imports, then they may feel that the Soviet economy is quite vulnerable to Western trade sanctions and it really does not matter what the real dependence of the Soviet economy on imports is. The Soviet response to Western economic sanctions will then be governed by the perceived and not the actual vulnerability of the economy to these sanctions. In addition, our knowledge of the value of Soviet exports and imports in domestic prices contributes important implicit information about the relative price distortions of the actual domestic price structure vis-a-vis the prevailing relative price structure on the world market.

The second measure, i.e., the ratio of exports or imports at comparable world market prices to national income measured at the same comparable world market prices, is inferior to the first, but greatly superior to the third measure. It utilizes world market prices which the scarcity prices indicative of the opportunity cost of different commodities on a worldwide scale. In an open economy, most of the domestic prices of traded goods will move in the direction of world market prices. Actual equality of domestic and world market prices will not take place because of transport cost and various market imperfections. Nevertheless, economists generally have a strong preference for using world market prices in calculations of a country's trade dependence in all cases in which domestic prices are seriously distorted.

We shall perform a simplified calculation of the second measure and compare the results of this calculation with the results implied by the Kostinsky-Treml study. The following data are needed for the calculation:

Soviet exports and imports in world market prices measured in dollars.

Soviet GNP measured in dollars and in world market prices.

Soviet trade with the developed West and with developing countries is conducted typically at world market prices and its dollar value can be obtained readily by converting official Soviet ruble trade statistics into dollars using the official dollar/ruble exchange rate. Soviet trade with CMEA countries and other socialist countries reported in official statistics has to be adjusted for the impact of preferential Soviet pricing of exports (e.g., low price for exported oil, gas, and various raw materials) and disadvantageous pricing of Soviet imports (e.g., high price for imported Cuban sugar and East European machinery and other manufactures). Thus official Soviet ruble trade statistics should be converted into dollars using derived dollar/foreign trade ruble exchange rates in which account is taken of differences in world market and intra-CMEA price level for particular commodity categories. Finally, in the absence of an estimate of Soviet GNP at world market prices, we propose to use a substitute—a U.S. Government estimate of Soviet dollar GNP arrived at by revaluing Soviet GNP components in dollars according to the relationship between the United States and the Soviet sectoral price levels. Although this estimate probably suffers from an "index number problem," at the present time it is the closest measure which we have suitable for our purpose.

The detailed calculation of the Soviet trade dependence is presented below in the appendix. Its main result is:

Whereas the Kostinsky-Treml calculation shows imports to amount to 20 percent of Soviet ruble net material product or 15 percent of Soviet ruble GNP, our calculation based on world market dollar prices shows imports to represent a mere 4.1 percent of Soviet dollar GNP.

In the case of exports, the Kostinsky-Treml calculation puts these at 7 percent of Soviet ruble net material product or 5.2 percent of Soviet ruble GNP, while our calculation based on world market dollar prices shows them to represent 6 percent of Soviet dollar GNP.

The major discrepancy between the Kostinsky-Treml results and our results of the calculation of Soviet import dependence can be attributed to the distorted relative price structure within the Soviet economy. In particular, the discrepancy in the two calculations can be explained by the relatively high Soviet internal domestic prices of manufactured goods vis-a-vis prices of energy and primary raw materials. Since the Soviets tend to import mostly manufactured goods and export mostly energy and primary raw materials, it is possible for Kostinsky and Treml to conclude that Soviet imports account for 20 percent of net material product and exports account for a mere 7 percent, implying a Soviet external trade deficit at domestic prices of 60 billion rubles, while at the same time the Soviet Union enjoys a significant surplus trade position at actual transactional prices (5.2 billion foreign trade rubles) and even greater surplus at comparable world market prices (an equivalent of $27.2 billion).

In conclusion, we feel that the correct interpretation of the Kostinsky-Treml study is that it shows how seriously distorted and irrational the domestic Soviet relative price structure is. The study does not provide good information on the dependence of the Soviet economy on foreign trade. The interpretation that the results of the study tend to support the view that the Soviet economy is more vulnerable to Western economic sanctions than previously thought is, in our view, not warranted. If, however, the decisions of Soviet leaders are in fact completely based on biased assessment of their country's dependence on imports and they are likely to respond to Western economic sanctions on the basis of perceived and not the actual vulnerability to these sanctions, then the important contribution of the study is in showing us just how seriously misled the Soviet decisionmakers may be by their own statistics.

APPENDIX.—ALTERNATIVE VALUATIONS OF 1980 SOVIET FOREIGN TRADE

Region	In actual transactional prices (million foreign trade rubles)	Dollar/foreign trade ruble exchange rate	In world market prices (million dollars)	In domestic prices (million domestic rubles)
Exports:				
Eastern Europe	20,919	1.8423	38,539	NA
Other CPE's	5,947	1.7373	10,332	NA
Socialist countries	26,866	1.8191	48,871	NA
Developed West	15,862	1.5406	24,437	NA
Developing countries [1]	6,907	1.5406	10,640	NA
Nonsocialist countries	22,769	1.5406	35,077	NA
World	49,635	NA	83,948	32,000
Imports:				
Eastern Europe	19,095	1.0144	19,370	NA
Other CPE's	4,554	1.1561	5,265	NA
Socialist countries	23,649	1.0417	24,635	NA

APPENDIX.—ALTERNATIVE VALUATIONS OF 1980 SOVIET FOREIGN TRADE—Continued

Region	In actual transactional prices (million foreign trade rubles)	Dollar/foreign trade ruble exchange rate	In world market prices (million dollars)	In domestic prices (million domestic rubles)
Developed West [2]	15,733	1.5406	24,239	NA
Developing countries [1]	5,093	1.5406	7,845	NA
Nonsocialist countries	20,826	1.5406	32,084	NA
World	44,475	NA	56,719	92,000

[1] Including Laos.

[2] Including special imports of pipe and pipeline equipment.

Source: Column (1)—Official statistics from 1980 Soviet Foreign Yearbook; column (2)—official Soviet dollar/ruble exchange for 1980 was 1.5406 dollars per $1; estimates of conversion rates for Soviet trade with Eastern Europe and other CPE's were made by Wharton; column (3)—column (1) multiplied by column (2); and column (4)—estimates by Kostinsky and Treml as reported in the press.

ALTERNATIVE MEASURES OF SOVIET NATIONAL INCOME IN 1980

Net material product (official Soviet figure)=458.5 billion domestic rubles; Gross national product (Wharton estimate)=611.3 billion domestic rubles,* Dollar gross national product (U.S. Government estimate)=$1,392.5 billion.

[From the Wharton Econometric Forecasting Associates, August 6, 1982]

MEASURING THE ROLE OF FOREIGN TRADE IN THE SOVIET ECONOMY

(By Vladimir G. Treml)

The July 14 CPE Current Analysis focused on recent U.S. Department of Commerce comments concerning the openness of the Soviet economy to foreign trade. In this issue Professor Vladimir Treml of Duke University, one of the authors of the study which the Commerce Department used as a basis for its comments, responds.

In a recently completed study done under the auspices of the Bureau of the Census [1] my colleague and I offer estimates of Soviet foreign trade valued in domestic prices and measurement of Soviet dependency on foreign trade.

The data are summarized below.

SOVIET FOREIGN TRADE

[Billions of current rubles]

	Exports			Imports		
	Foreign trade rubles	Domestic prices	Percent of NMP [1]	Foreign trade rubles	Domestic prices	Percent of NMP [1]
1960	5.0	5.3	3.7	5.1	12.0	8.3
1965	7.4	8.4	4.3	7.2	15.7	8.1
1970	11.5	18.3	6.3	10.6	24.9	8.6
1975	24.0	22.9	6.3	26.7	54.4	15.0
1980	49.6	31.8	6.9	44.5	92.3	20.1

[1] Editor's note.—Net material product is a measure of national product comparable to GNP minus most services and depreciation. It is approximately three-fourths of what Soviet GNP would be.

In our Bureau of the Census study and elsewhere we endeavor to show that the Soviet dependence on foreign trade measured in domestic prices is much greater than perceived earlier and that it was rising rather dramatically in the 1970's. However, our measure of Soviet dependence on foreign trade should not be used as an absolute index of Soviet vulnerability to external forces but as evidence of rapidly growing vulnerability. The fact that only about one-third of Soviet imports (when measured in dollars) comes from the West clearly limits the effectiveness of economic leverage available to the West.

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*Assuming the GNP/NMP ratio for 1980 of 1.3333.

[1] Vladimir G. Treml and Barry L. Kostinsky, "The Domestic Value of Soviet Foreign Trade," Foreign Demographic Analysis Division, U.S. Bureau of the Census, (Washington, D.C.: Government Printing Office, fall, 1982). The data for 1980 are not in the source cited (in which the data series end with 1978) but were roughly estimated by me by the methodology developed and documented in the study.

Our results were critically examined in the Wharton Current Analysis of July 14, and I would like to discuss some of the issues raised.

The Wharton newsletter lists two empirically feasible measures of a country's foreign trade dependency:

The ratio of exports or imports (or of the sum of the two) measured in comparable world market prices to national income measured in the same world market prices.

The ratio of exports or imports measured in actual domestic prices to national income measured in domestic prices.

Because of the well-known shortcomings of domestic Soviet prices the Wharton newsletter suggests that the first measure is by far the preferable one and that the second measure "does not provide good information on the dependence of the Soviet economy on foreign trade."

Wharton's argument in favor of world market prices is that these are "scarcity prices indicative of opportunity cost of different commodities on a worldwide basis" which, of course, is difficult to object to. In the absence of a measure of Soviet GNP in world market prices, the Wharton newsletter proposes using as a "substitute" the dollar value of Soviet GNP as estimated by the CIA. The Soviet dependency ratios are then calculated on the basis of actual dollar transaction prices of Soviet exports and imports (adjusted for price dislocations in intra-CMEA trade). Calculated in this manner, for 1980 the exports amounted to 6 percent of GNP and imports 4.1 percent.

One can start by arguing that, even if we were to have a complete knowledge of all necessary Soviet and U.S. price and quantity data for comparable goods, the Soviet GNP converted to U.S. dollar prices could be hardly said to reflect world price relatives. Because of the dominant position of the United States in the world economy, U.S. domestic prices of goods traded internationally are probably close to world market prices. However, a large subset of U.S. goods and services is not traded outside of the country and the prices of this subset do not reflect worldwide market forces.

But this is not the end of the story.

One of the strongest arguments against the use of dollars or world market prices is the index number problem. It will be recalled that both theoretical and applied studies suggest that, as long as prices and quantities are inversely related, comparisons of national aggregates (GNP, NMP) of two different countries will vary depending on whether prices of one or the other country were used. Thus, the ratio of national incomes of countries A and B will be higher when measured in B prices than when measured in A prices. For instance, the ratio of Soviet to U.S. GNP for 1976 was estimated as 73.7 percent when measured in dollars and only 49.5 percent when measured in rubles.[2, 3]

But, in order to fully evaluate the distortive effect of the index number problem on the dependency ratio of the foreign trade/national income type we must look at the numerator as well as the denominator. The proof is rather cumbersome, but it should be intuitively clear that the logic of the index number effect applies to foreign trade. Countries export commodities which are relatively abundant at home and that are, therefore, relatively inexpensive and import commodities which are scarce and expensive at home. Since the outside world buys the exports and sells the imports to the country we are examining, the relative scarcities and prices on the world market must move, therefore, in opposite directions from domestic scarcities and prices.

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[2] Imogene Edwards, Margaret Hughes, and James Noren, "U.S. and the U.S.S.R.: Comparisons of GNP," In Joint Economic Committee, U.S. Congress, "Soviet Economy In a Time of Change," Volume 1, (Washington, D.C.: Government Printing Office, 1979), p. 378.

[3] In order to partially correct for the index number effect, CIA analysts convert the estimated ruble component of Soviet GNP into dollars by applying the "average purchasing power ratio of the dollar and the ruble" calculated as a geometric mean of individual ruble-dollar ratios weighted by both United States and Soviet expenditure weights (CIA NFAC, "Handbook of Economic Statistics," Washington, D.C., 1981, p. 29.). The final effect, in terms of the example given above, would be that the Soviet/U.S. GNP ratio in dollars (or, in rubles, as with this approach there is no difference) is 60.4 percent.

This adjustment is justified for the purpose of United States-Soviet comparison, but is undesirable for the dollar measure of Soviet GNP used by Wharton. The degree of overstatement of the Soviet GNP produced by the conversion to dollar prices is reduced but, on the other hand, the dollar prices are now even further away from world market prices.

Here we must introduce a complicating factor. The Soviet ruble is inconvertible and the U.S.S.R is trading in world markets in terms of external prices, which are different from domestic prices. Historically, the U.S.S.R. tried and almost always succeeded in balancing her commodity trade in external prices which also meant that the foreign trade was not balanced in domestic prices. I will return to this point later, but in the meantime we can note that it can be shown that, for a country which balances its trade in external prices, the foreign trade dependency measure calculated as the ratio of the sum of exports and imports and national income will always be lower when expressed in external prices as compared to the ratio based on internal prices.[4]

As a rule, therefore, the index number effect is compounded in the case of foreign trade/national income measurement, as the denominator is overstated and the numerator is understated.

There are other compelling arguments against the use of dollar prices in the measurement of the Soviet dependency ratio.

The Soviet GNP in dollars used in the Wharton newsletter was estimated by the CIA. I have worked with these estimates and in my opinion they are quite good both in terms of the methodology and accounting conventions used and in the meticulously careful collation and adjustment of the original data. But, they are still estimates and given the lacunae and uncertainties of Soviet statistics, they are rough estimates with benchmark years being somewhat better and the estimates for other years suffering from price-adjustment and other problems. Thus, the accuracy of the denominator for the dollar measure of the dependency ratio is rather uncertain or at least cannot be seriously viewed as accurately showing Soviet GNP in world market prices.[5]

The measure of dependency on foreign trade based on exports and imports in domestic prices and on official Soviet figures for national income (Net Material Product) has, in my view, several advantages.

The foreign trade flows are measured in actual final transaction prices, i.e., prices at which they are recorded in national income accounts. Exports are measured in prices received by export manufacturers and imports are recorded in prices at which they were purchased by final consumers.

All the shortcomings of the Soviet price system and idiosyncrasies of Soviet national income accounting notwithstanding, we know what we are dealing with and we are operating with value magnitudes which are used in the U.S.S.R. Soviet prices are, after all, not just random numbers and totally irrational. Domestic prices, particularly domestic prices of exports and imports, regardless of how much they depart from scarcity prices, are set by Soviet authorities and therefore reflect the priorities of these authorities.

It is now quite apparent that the Soviet domestic price system is no longer fully insulated from world market forces. In the 1967 and in subsequent price reforms, Soviet price authorities attempted, albeit with mixed results, to move Soviet price relatives closer to world market prices. Much more research will be required, but it is quite clear that at least some domestic prices are influenced by or are directly linked to world market prices.

It would be helpful to touch upon the issue of accounting of foreign trade flows as it bears directly on the problem of evaluation of exports and imports.

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[4] An interesting point is that the export/income ratio will be higher in external prices and the import/income ratio will be higher in domestic prices. The ratio of the sum of exports and imports will always be higher in domestic prices. The measurements offered in the Wharton newsletter bear this out. Exports are 6 percent of Soviet GNP in dollars compared with 5.2 percent when measured in rubles. Imports based on dollars are 4.1 percent and 15 percent when based on ruble prices.

[5] It is interesting to note that, bearing all these problems in mind, the authors of the CIA study specifically ask the readers not to use the Soviet dollar GNP estimates in conjunction with the Soviet foreign trade data in dollars. (CIA NFAC, "Handbook of Economic Statistics," Washington, D.C., 1981, p. 29.)

One other factor must be taken into account. Regardless of whether we use ruble or dollar prices, the Soviet foreign trade flows must be expressed in purchasers' prices because GNP and NMP are measured in purchasers' prices. The dollar values of foreign trade used in the Wharton example are as recorded in Soviet sources, i.e., exports are valued FOB Soviet border and imports are FOB port of foreign departure. The problem of correct valuation of exports is moot, but it is quite clear that the value of imports should have been adjusted upward to reflect the cost of transportation and distribution between the Soviet border and the final consumer. Omission of these charges, therefore, understates the value of imports. (Approximate estimates indicate that transportation and distribution charges amounted to about 10 percent of the value of imports measured in domestic purchasers' prices in 1972. It is difficult to say what the charges would have been in 1980 or in dollar prices.)

The July 14 Wharton newsletter questioned the inconsistency perceived in our study which "implied an external trade deficit at domestic prices of some 60 billion rubles and a 5.2 billion foreign trade ruble export surplus at the same time."[6]

It must be remembered that the Soviet ruble is inconvertible and foreign trade is conducted at external prices and in currencies of other countries. Therefore, the Soviet Union has two foreign trade balances—the one in external values indeed showing an export surplus in various external currencies converted by means of the official exchange rate to 5.2 billion so-called "foreign trade rubles," and the second showing the excess of revenues of some 60 billion rubles derived from sales of imports to domestic consumers less domestic costs of exports. The latter is thus not a "trade deficit" in a usual sense of the word, but a surplus realized from price differences and constituting a rather handsome source of revenue for the state treasury.

The explanation of the persistent and significant excess of revenues from imports over the costs of exports would be beyond the scope of this note. But, we should note that in addition to the usually cited factors such as price differences, difference in quality, and turnover taxes, the export-import imbalance in domestic prices is the result of the Soviet traditional policy of balancing the trade in external values. The actual magnitude of the gap depends on the structure of foreign trade and the prices. For instance, I expect that, as the result of the 1982 Soviet price reform, the gap will be significantly smaller.

The existence of two trade balances with different signs is thus fully consistent with Soviet national income flows. In fact, it makes the use of domestic values of Soviet exports and imports even more important as they reflect the tie-in between foreign trade and the state budget of the U.S.S.R.

Domestic values of exports and imports are thus real transaction values fully consistent and integrated with other transaction flows of the Soviet economy and their shares in national income are an important measure of Soviet dependence on foreign trade.

The measurement of dependence on foreign trade by the ratio of exports and imports to GNP in dollars appears to be inappropriate for most analytical purposes because of the downward bias resulting from the index number effect and uncertainties surrounding the estimates of Soviet GNP in dollars, particularly the uncertainties concerning the correspondence between dollar prices used in the Soviet GNP estimates and world market prices.

APPENDIX: EDITOR'S REPLY

Professor Treml objects to Wharton's calculation of Soviet foreign trade dependence on three grounds, namely:

The numerators in export/GNP and import/GNP ratio are respectively biased upward and downward because of an "index number problem," i.e., *hypothetical* Soviet scarcity prices should be lower than world market prices for exports and higher for imports.

The denominator in both of the above ratios is biased downward because he feels that Soviet dollar GNP at "world market prices" would be lower than Soviet dollar GNP at U.S. prices estimated by CIA (note: for 1980 CIA estimated Soviet dollar GNP at 53 percent of U.S. GNP).

Soviet imports should be measured on a c.i.f. rather than a f.o.b. basis in order to express trade flows in purchasers' prices.

Since Professor Treml does not make suggestions as to the suspected magnitude of bias in our calculation except in the third case, we will try to satisfy at least the latter two of his objections by making the following adjustments in our calculation of Soviet export/GNP and import/GNP ratios:

Instead of using a CIA estimate of 1980 Soviet dollar GNP of $1,392 billion, we shall assume that Soviet dollar GNP at world market prices was a mere 40 percent of U.S. GNP or $1,050 billion (note: this is intentionally an absurdly low estimate since as Professor Treml points out already in 1976 the ratio of Soviet to U.S. GNP measured in rubles was 49.5 percent).

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[6] The July 14 newsletter goes on to say that the export surplus is even greater at comparable world market prices—an equivalent of $27.2 billion. This estimate is difficult to accept and its nature illustrates very well the problems of dealing with artificial values. The $27.2 billion figure was arrived at by repricing Soviet exports at average world market prices instead of lower prices charged by the Soviet Union in trade with Comecon nations. Knowing how carefully Wharton estimates are made I have no doubts concerning the accuracy of the estimate. But, what does it mean? Could the Comecon nations pay some additional $20 billion for Soviet imports, were they priced at world levels? Is demand for imports from the U.S.S.R., even for energy imports, perfectly inelastic? I submit that if the U.S.S.R.-Eastern Europe trade were to be actually shifted to world prices the whole trade system would probably collapse and, after a painful realignment, a completely different set of world market prices would emerge.

We shall increase the value of Soviet imports from Eastern Europe by 5 percent and from all other regions by 10 percent in order to convert Soviet data from a f.o.b. to a c.i.f. basis.

These two changes would have the following effect on our calculation of Soviet foreign trade dependence in 1980 presented in our July 14 Current Analysis:

[In percent]

Region of trade	Export/GNP ratio		Import/GNP ratio	
	At actual transactional prices [1]	At world market prices	At actual transactional prices [1]	At world market prices
Eastern Europe	3.07	3.67	2.94	1.94
Other Socialist countries	0.87	0.99	0.73	0.55
Socialist countries	3.94	4.66	3.67	2.49
Developed West	2.33	2.33	2.54	2.54
Developing countries	1.01	1.01	0.82	0.82
Non-socialist countries	3.34	3.34	3.36	3.36
World	7.28	8.00	7.03	5.85

[1] Soviet ruble trade with socialist countries was converted into dollars at the official dollar/ruble exchange rate of $1.5406 per one ruble.

The above results lead us to the following conclusions:

Soviet exports compromise 8.0 percent (7.3 percent without adjustment for price bias in socialist country trade) of Soviet dollar GNP compared to 5.2 percent estimated by Professor Treml.

Soviet import/GNP ratio is 3.8 percent (7 percent without adjustment for price bias in socialist country trade) compared to 15 percent estimated by Professor Treml.

Given the mere 2.8 point discrepancy in two estimates of export dependence which Professor Treml would attribute to the "index number problem," it is hard to accept the discrepancy of 9.2 points between the two estimates on the import side as explainable by the "index number problem" alone. If we assume, for the sake of argument, a downward bias of 50 percent in our calculation, then our estimate of import/GNP ratio would still be at most 8.8 percent—less than three-fifths of Professor Treml's estimate.

We would like to emphasize that while we agree with Professor Treml's observations that the ratio of Soviet trade to national product grew rapidly during most of the 1970's, we would not characterize any of the above figures as an index of Soviet vulnerability to external forces. The most relevant figure in the above table for the discussion of sensitivity of the Soviet economy to sanctions is the dependence of the Soviet economy on imports from the developed West. And this is shown to have reached only 2.5 percent by 1980. We fail to see how one can conclude from this that the Soviet economy is vulnerable to Western economic sanctions in a global—not micro—sense.

Moderator **Hardt**. Thank you very much, Dr. Vanous.

Of course, in our deliberations it is extremely important to understand and make an assessment as to how important Western trade is to the Soviet Union in terms of the trade impact on their economic performance. This assessment is the basis of Soviet perception of what is important, because if indeed we are to use economic influence in political and international affairs, it is important to understand better what the perceptions are in the Soviet Union as to the importance of trade and the specific nature of trade.

Dr. Treml has been working on the Soviet economy for a number of years, particularly in assessing their economic performance through their input/output tables and analyses. From the time he worked on his Ph. D. at the University of North Carolina he has been the leader in this new and important area of assessment. In doing this he has of course been concerned about how Soviet foreign trade fits into this general macroeconomic framework.

His recent publication with Barry Kostinski dated October 1982 entitled "Domestic Value of Soviet Foreign Trade—Exports and Imports in the 1972 Input/Output Table" is one of a series of his assessments in this important area. I say that because some of you have heard about this contribution in the media and it is important to put this paper in the context of his long-term assessment in this field. He will give us some of the highlights of his assessment in his oral comments.

STATEMENT OF VLADIMIR G. TREML, PROFESSOR OF ECONOMICS, DUKE UNIVERSITY, DURHAM, N.C.

DEPENDENCY AND VULNERABILITY

Mr. TREML. Thank you, John.

I was just going to preface my statement in exactly the same terms, that my main interest in analyzing the Soviet economy is in, if you want to, in internal terms; that is, I am merely concentrating on internal ruble prices.

Dr. Vanous and I have a disagreement. I believe that either the most important or at least one very important measure of the dependence on foreign trade must be expressed in internal rubles as relating the value of exports or imports in domestic rubles, the prices which are paid by ultimate consumers of imports in rubles and the prices which are received in rubles by Soviet manufacturers of exports, and relating these values to national income.

One of the results and one of the products of our research at the Department of Commerce was to realize that for a number of reasons Western specialists have understated the overall value of Soviet foreign trade measured in domestic prices. You know, a survey of most Western works on this topic would yield ratios of exports or imports to Soviet net material products of 3 to 5 percent.

Our recent estimates based on Soviet statements and Soviet statistics, show that in fact, the ratio of Soviet exports to national income is about 7 percent. That is not counting gold which I think should be counted as part of Soviet exports. Including gold would boost it to about 7½ percent. Soviet imports are as high as 20 percent of Soviet net material product.

Soviet foreign trade is important in a number of other respects. It is virtually impossible to estimate accurately, but anywhere from 10 to 20 percent, and 20 percent is probably a bit high, but 10 percent up of all Soviet budget revenues are derived from net profits from foreign trade.

So our main conclusion was that in the last 15 years or so since the mid-1960's the whole nature of the Soviet economy has changed dramatically in a direction of dependence on external trade and a dependence on imports.

In overall terms, today probably up to 20 percent of new installed machinery in capital investment are derived from imports. Fifteen percent and higher of total Soviet consumption is derived from imports. If you convert feed grain to meat, about 20 percent of meat on an average for the last 5 to 7 years consumed by Soviet citizens is of foreign origin. As Dr. Vanous pointed out, in some industries these ratios are much higher.

I just recently read a Soviet report that 60 percent of the Soviet merchant marine carrying capacity consists of imported ships. Now this sort of observation directly relates to the issues of defense and defense industries that Dr. Hewett was referring to. The Soviets were building up their shipbuilding capacity very actively in the 1950's, and apparently managed by importing 60 percent, and the Soviet merchant marine is I believe the largest in the world in terms of dead weight. The ability to import such a large percent of the merchant shipping enabled them to convert—the shipbuilding industry was always considered part of their defense industry—enabled them to convert a large share of capacity to naval shipbuilding and military shipbuilding. Also, of course, and it is well documented, one of the fastest growing navies in the world is the Soviet.

In the chemical industry 50 percent of existing capacity in terms of machinery and equipment is imported.

In textiles, food, paper, some types of woodworking industries and metal industries anywhere from 15 to 25 percent of installed machinery and equipment is of imported origin.

Incidentally, I believe that the Soviet leadership is becoming increasingly concerned with the vulnerability or dependence. Brezhnev and Tikhonov have several times referred to a dangerous dependence on imported foodstuffs. Brezhnev on a couple of occasions referred to machinery. The president of the Academy of Sciences of the U.S.S.R. quite recently expressed concern and dismay at the dependence of the Soviet scientific establishment on imports.

He, and I am just quoting him, said that 70 percent of technical apparatus, measuring devices and instruments are of external origin. I don't know whether he was referring to total or Western. But of course 70 percent is a very significant number.

I also agree with Dr. Vanous that somehow the media or even specialists have overstressed the importance of sort of the state of the art, the high technology. Most of it probably finds its way to the Soviet Union through illegal or gray markets and is not imported.

However, I do not agree with Dr. Vanous that the Western imports of machinery are of secondary importance. For the last 10 years I have done a lot of work on the Soviet machine building industry. I think that basically relative to the development of world machine building the Soviet civilian, or nonmilitary machine building industry did not do too well in the last 10 to 15 years. They are engaged in mass production of relatively crude, simple, heavy, and inefficient machinery which they export and use domestically and they rely to an increasing degree on imports of not, again, state of the art, not sophisticated, but simply high quality standard world-traded machinery.

Apparently they cannot, although they were hoping, and there were a number of studies and projects in the late 1960's and the early 1970's, that they would be able to dominate certain markets or at least export large shares of their machinery. They failed in this. They succeeded in some sense. For instance, they do now export passenger cars. But, for instance, 2 years ago an average American car of six cylinders and less was selling in Belgium for about $4,500 and an average Soviet passenger car of six cylinders or less was selling for $1,200. This sort of gives you the range of the quality differentials which Soviets cannot somehow overcome.

No matter what products you consider in Soviet foreign trade you will find that they are exporting inexpensive, mass produced items, final machinery or components, and they import high quality products. The Soviet Union has by far the largest ball bearing industry in the world. They are producing now over 1 billion ball bearings a year and they export a very large share of it. Nevertheless, while the ball bearing productive capacity doubled in the last 15 years, they increased the imports of ball bearings sevenfold. They export ball bearings roughly at the price of about $1.50 per unit and they import ball bearings roughly at $3 a unit. So the high precision and high tolerance ball bearings, are important.

According to one of the senior Soviet specialists in machine building, 50 percent of programed machine tools, multilathe machine tools, utilize imported components, particularly electronic controlling devices. They are heavily dependent on imports of communication cable.

Again, I am not talking about state of the art technology. These are generally available. For one reason or another they have failed to improve their own performance and now are relying on imports.

In some sense, we also underestimate the importance of imports or the dependence on imports because we are forced into use of whatever dollar prices. The Soviet is a very taut system. The supplies are deficient. The whole system of industrial planning and supply generates bottlenecks and shortages, and deliveries are not made on time.

If you would review Soviet technical literature you will find numerous examples of, say, a construction project, a major construction project frozen simply because the plants which ordered certain components and parts were ordered were 2 years behind or 3 years behind schedule. In a number of instances, well documented in the Soviet literature, the Soviet engineers and managers in charge of construction projects had no choice but to go to Western sources of supplies of machinery and components.

Now sometimes we don't really know whether they have to go to the Western or East European socialists sources, but simply because most of the East European production is also planned and to some extent integrated with the Soviets, when they urgently need certain types of machine tools or certain types of components, unless they would want to see a major construction project stopped or slowed down, it is most likely they are going to the Western sources.

One thing which is widely discussed now in the Soviet technical literature is that apparently in the production of lathes and machine tools there is a general trend in the world away from alternating current in favor of direct current motors.

The GOSPLAN for some reason failed in projecting the production of these motors and Soviet machine building plants are demanding these motors and have no choice but again to go to the

Western market. There are a number of examples like this, when at the margin the price, the shadow price, if you want to, the true opportunity cost would be extremely high. That is something we cannot measure, but you have a clear picture of these dependencies from the Soviet literature.

I really should not address myself to the issues of sanctions because I am not a specialist in diplomacy or in foreign relations. I am very much impressed by the change in the Soviet economy and by the degree to which the Soviet economy has opened up in the last 15 years.

One thing which I did not mention, but from a totally closed economy of 20 years ago, basically self-reliant and self-sufficient, not only did they open the doors to a huge flow of imports, but they also now allow direct transmission of price signals from abroad to the Soviet Union, to the Soviet economy. It happens in the case of machinery and it happens in the case of a number of consumer goods.

The textbooks on the Soviet economy, the Soviet textbooks still maintain that the Soviet Union is totally isolated from the rest of the world and protected from world inflation and world price signals. This is not the case any more and Soviet economists themselves in more technical literature testify to the import of inflation, say, in the form of machinery and in the form of consumer goods.

Just one or two considerations concerning the dependency, vulnerability, and sanctions. I fully agree that it is very difficult to imagine how the West or the United States could design a system of sanctions or denials which would bring the Soviet Union down and which would force the Communist Party to disband or things like this. But I do not view sanctions as one single type of measure. I view it as a matrix of possible and feasible denial measures which would not be too costly to the West or the United States, and at the same time because of this heavy reliance on imports in a number of Soviet markets, I am positive there is a list or a set of concessions the Soviet Union would be willing to make in order to avoid certain types of confrontation.

The West or the United States for some reason did not explore this matrix and did not prepare a set of such sanctions and this is regrettable because the Soviet Union did slow down in its rate of economic growth since the early 1960's and, if anything, the Western economies have aided them in the process over the last 15 years.

If I may just take 1 more minute of your time, with a very instructive example. It is not quite parallel, but I still think it is quite interesting. There is the well-known case, and historical by now, the case of the Soviet gold reserves. In January of 1964—it is far back—the CIA had for one of the first times a press release at a press conference announcing a study indicating that the Soviet economy was growing much slower than heretofore believed in the West and, second, also that the Soviet gold reserve was half of what was generally believed at that time, and Soviet production of gold was half of what was generally held. By generally held I mean according to estimates made by West European specialists, the Bureau of Mines and academics.

At that time the Soviet Union and the East European countries began to explore the possibility of long-term credits from the West and President Johnson's administration was actively opposed to it. The CIA and the White House and the U.S. Government was criticized in Western Europe and in the United States by academics for politicizing the issue of commerce. In fact, the CIA was accused on a couple of occasions of just doctoring the data, and the West Europeans, the British, and the gold dealers simply refused to accept the figures.

About 6 or 7 years later most specialists in gold turned around and now have come to fully accept the CIA estimates. There would be an adjustment up and down of plus 5 percent, but that time, of course, Western Europe actively explored extended credits to the Soviet Union. Accepting the earlier estimates it was assumed that the Soviet Union was extending this gold umbrella over trade because if you would convert the Soviet gold stock at $35 per ounce you would have a very sizable amount of gold as international payment. In fact for a number of years it was assumed that ultimately the long-term credits extended to Eastern Europe and the U.S.S.R. are fully covered by the Soviet gold stock.

This is history of course. The U.S.S.R. and Eastern Europe ran up a long-term debt of, $66 billion or $67 billion, excluding Yugoslavia.

Mr. Vanous. For Eastern Europe about $54 billion.

Mr. Treml. So we have about a $60 or $65 billion debt. The Soviet gold stock now estimated by the Central Intelligence Agency and most Western specialists, even assuming they would sell it, and of course they would not sell it immediately because they would lose value, but say at my latest estimation of $400 per ounce, it would cover not more than $20 million of this debt.

I am not saying that long-term credits should not have been extended, but if there was any promise of reduction of international tensions and some sort of accommodation with the U.S.S.R. of decreased political pressures on Eastern Europe, I think maybe the gamble of extending credit was worth it. But what is sort of annoying to me as an academic was the fact that this was not taken into account and as a result we have problems or potential default by Poland, by Romania, and by Yugoslavia, the latest case with highly unpleasant consequences for the entire world.

Thank you.

[Mr. Treml's prepared statement follows:]

Prepared Statement of Vladimir G. Treml

1. In the last 15 years or so the role played by foreign trade in the Soviet economy underwent far reaching and significant changes, although Western specialists differ in their assessment of both qualitative and quantitative magnitude of these changes.

Historically, the generally accepted view of the Soviet economy has been that it is largely self-sufficient as evidences by relatively low shares of exports and imports in national income. These ratios termed trade participation ratios have been variously estimated by Western economists as ranging between 3 and 5 percent each. The Soviet economy was also believed to be a relatively closed one with the state monopoly of foreign trade and the inconvertibility of the ruble effectively insulating the domestic economy from external influences.

This description may have been acceptable through the early 1960's but it is clearly inaccurate if not outright wrong when we look at Soviet foreign trade in the 1970's.

For the past several years, both at Duke University and at the Census Bureau, my colleagues and I have been engaged in research of Soviet foreign trade focusing on domestic values of Soviet trade flows, i.e., prices paid by ultimate buyers of imported goods and prices received by manufacturers for goods produced for export, on methods of setting these prices, and on the distribution of exports and imports among various sectors of the Soviet economy in domestic prices.

Our research led us to conclude that in the 1970's the Soviet economy became much more open and integrated with world markets, and that while the basic mechanism of administration of foreign trade was still intact, the domestic prices of a number of groups of imported and exported commodities were now directly or indirectly linked with world market prices thus contributing to the "openness" of the economy.

More specifically, we found that in the 1970's the absolute magnitude of exports and imports measured in domestic prices[1] was much higher than believed earlier. Our study is carried through 1978 but we can derive some rough estimates for 1980 using the same procedures.

The export (commodity exports and gold) participation ratio increased from 6.3 percent of Soviet national income in 1970 to 7.7 in 1978, and dropped to 7.1 in 1980.

The import participation ratio rose from 8.6 percent in 1970 to 16–18 percent in 1978, and 18–20 percent in 1980.

Preliminary estimates for 1982 indicate that the shares will continue to rise, particularly on the export side, because of the upward revision of Soviet internal prices for energy resources which account for the bulk of Soviet export trade. It should be noted that these ratios are based on the Soviet definition of national income (Net Material Product). Were we to use the Western concept of Gross National Product as a base, the 1980 export participation ratio would be about 5.5 percent and the import ratio about 15 percent.

It should be stressed that Soviet internal prices are administratively set and often do not reflect the true scarcity values or the resource content of commodities and the same observation applies to internal prices of imports and of goods produced for export. The trade participation ratios cited above are based on actual Soviet prices and the official values of Soviet national income and the possible distortions created by state-fixed prices are carried through to these ratios.

It is impossible to say or even to guess without much additional research what the trade participation ratios would have been were the foreign trade and national income flows repriced in true scarcity or market clearing equilibrium prices.

One observation concerning prices of imported machinery is, however, in order.

It must be emphasized that the Soviet industrial planning and supply system is rather taut and orderly planned deliveries of inputs into production are often disrupted. On frequent occasions production of parts, semifabricants, and components planned at a given plant or ministry falls behind schedule creating serious problems for producing enterprises requiring these intermediate inputs. In these situations foreign markets particularly Western foreign markets are often the only source of these critically needed inputs particularly in machinery manufacturing with its high level of subcontracting. Soviet technical literature provides numerous examples of machinery producers or of disrupted capital construction projects which were bailed out by imported machinery or components, the domestic supply of which was for one reason or another not on schedule.

Because of chronic trade deficits with "hard currency" nations the approval of imports of Western machinery is never given lightly by the Ministry of Foreign Trade of the U.S.S.R. and we can assume that these intermediate imports are indeed critically needed. Obviously, the true scarcity value of these inputs are much higher than indicated by the prices paid by importing enterprises and one could speculate that the true dependence at least on imported Western machinery is higher than described by computed trade participation ratios.

Dr. Jan Vanous of Wharton Econometric Forecasting Associates has recently suggested that because of the nature of state-fixed Soviet prices the measurement of Soviet dependent on foreign trade in these prices does not reflect the true costs of resources and that instead the trade participation ratios should be expressed in dollar or world market prices. According to his estimates the participation ratios are much lower thus supporting his contention that the Soviet economy is a relatively closed one.

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[1] It must be explained that the officially published Soviet statistics report foreign trade flows in so-called "foreign trade" prices, i.e. prices expressed initially in various foreign currencies in which export and import transactions were made and then converted to rubles by means of official exchange rates. These "foreign trade" ruble prices may differ from actual internal prices at which exports and imports are exchanged within the U.S.S.R. by a factor ranging from 0.5 to 10.0. The main objective of our study was to convert the "foreign trade" prices which are mere accounting entries on the books of the Ministry of Foreign Trade and meaningless as far as the domestic economy of the U.S.S.R. is concerned into actual domestic prices.

I have carefully evaluated this proposition, and in my considered judgment the use of dollar prices is inappropriate. A technical note explaining the reasons is appended. But, in short, the main problem with Dr. Vanous's measures is the denominator of the ratio, i.e. the value of Soviet GNP which he takes to be in world market prices but which is, in fact, in arbitrary hybrid prices reflecting neither the true Soviet scarcity nor world market prices. Furthermore, the so-called index number problem produces a downward bias in the process of conversion of rubles into dollars.

2. I focus my attention on total Soviet foreign trade and not on trade by blocs such as the trade with the West or trade with CMEA countries. I fully appreciate the importance of differentiating the trade with other socialist countries from the trade with the developed West but I submit that we cannot engage in meaningful analysis of trade by separate blocs because of the absence of the necessary data.

The differentials between external dollar prices and domestic ruble prices vary depending on the commodity over a rather wide range. Thus, the ratio of the Soviet domestic price received by the export manufacturer or paid by the final consumer of imports to the dollar price of these goods in world trade range from 0.5 to 10. We have fairly reliable statistics on Soviet trade with individual countries when these statistics are based on external or dollar prices. The shares of individual countries in Soviet exports or imports measured in domestic prices are not available and hence the impact on the Soviet economy of imports from, say, Western European countries cannot be analyzed.

The second reason for focusing on total trade not differentiated by trading blocs is that, to the best of my knowledge, Western specialists have never estimated the share of East European imports from the West which was necessary to sustain the exports of these countries to the U.S.S.R. In 1980 the U.S.S.R. imported 15 billion rubles worth of machinery out of which about two-thirds came from CMEA countries. However, the CMEA countries, in turn, imported some 5 billion rubles worth of machinery from the West. How much of this was needed to ship 10 billion rubles of machinery to the U.S.S.R.? We do not know.

3. Soviet dependence on imports is reflected in the fact that in the late 1970's between 15 and 20 percent of all newly installed machinery and equipment is accounted for by imports, while imports of grain and other foodstuffs (particularly oilseeds, meat, sugar, vegetable oils, and fruits) comprise significant shares of Soviet people's consumption.

Soviet dependence on imports is not uniform in different branches and sectors of the economy. Accurate figures cannot be obtained without much additional research but accepting the possibility of a ±10 percent error we should note that imported machinery and equipment comprised over 50 percent in the chemical industry and about 20 percent in processed food, woodworking and paper, textiles, and metallurgical industries. More than 60 percent of the carrying capacity of the Soviet merchant marine consists of imported ships, imported rolling stock and buses comprise large shares of the carrying capacity of the land transportation system. According to one report domestic industry supplies only one-third of instruments and gauges used by the Soviet scientific establishment.

Intermediate inputs and components play an equally important role in Soviet manufacturing; thus we hear reports that almost one half of Soviet programmed lathes are equipped with imported components.

Imports play an equally important role in providing food and soft goods for consumption. In the late 1970's probably as much as 15 percent of retail trade turnover consisted of imported goods.

The increasing dependence of the Soviet economy on imports is becoming a matter of growing concern to Soviet leaders. In the last 2-3 years Brezhnev, Tikhonov, and other high party officials referred to dependence on imported food stuffs and machinery and stressed the need of returning to a higher degree of self-sufficiency.

These policy issues have not been resolved. Some technical specialists echo the concerns expressed by the leaders while other, equally prominent specialists, urge expansion of imports of machinery "embodying" high technology as the most expedient way to improvement of efficiency of Soviet industry.

4. One often reads about the Soviet dependence on imported Western "high technology" but it is difficult to determine the quantitative dimensions of this need. However, analyzing Soviet imports of machinery at a disaggregated level one is im-

pressed by the apparent insatiable need not for "state-of-the -art" equipment but for standard, high quality, high tolerance, Western and some time CMEA machinery, equipment, and machinery components and parts. Even a casual scanning of Soviet lists of machinery exports and imports shows numerous examples when the U.S.S.R. exports in large numbers inexpensive, simple, mass-produced machinery or parts and imports in smaller number more sophisticated, better quality and more expensive machinery of the same type. It testifies to the fact that the Soviet machinery industry failed in the last 15-20 years to keep up with general world technological developments and to maintain and improve the quality of its products, except, perhaps in the military hardware and armaments. Without going into details of defining quality we may simply refer to numerous statements by planners, engineers, and managers of Soviet machine building enterprises suggesting that in general the quality of Soviet machinery is below world market level. In this connection, it is interesting to note that most Soviet enterprises producing the same machine for domestic and foreign markets find it necessary to provide for additional inputs of labor and material to insure that the export models are of higher quality and hence would be more competitive in world markets. In fact, special arrangements for higher quality of machinery earmarked for export have been routinely built in into costing and pricing at machine building plants.

5. Based on all this analysis, I conclude that Soviet participation in foreign trade and Soviet dependence on foreign trade rose dramatically in the 1970's. Combined with other evidence such as developing direct and indirect links between the domestic price system and world market prices, I submit that the old perception of the Soviet economy as self-sufficient and isolated from the rest of the world should be revised. The Soviet economy has become relatively much more open to external market forces and displays significant dependence on external markets.

There is clearly no one-to-one correspondence between the rising Soviet dependence on trade and the vulnerability of the Soviet economy to external forces. However, I think that it is reasonable to conclude that the development of Soviet foreign trade in the last 10-12 years has resulted in greater susceptibility to economic sanctions than was true in the past and than has been recognized by Western specialists. I wish to stress that this analysis and conclusions go no further than this and in no way address the question of the advisability, effectiveness, costs or consequences of sanctions against the U.S.S.R.

It should be noted that the issue of sanctions was entirely outside of the analysis I conducted in collaboration with the Bureau of the Census, but I would like to add these comments on this subject. There is no single yes-or-no answer to the question of the effectiveness of economic sanctions; there is, in fact, a complex matrix of possible scenarios. On the one hand, there is a whole range of sanctions available to the United States and its allies, varying from selective restrictions on exports of specific products to full-scale economic welfare. On the other, there must be a whole range of possible concessions the Soviet leadership would be willing to make, depending on the economic costs of Western sanctions to them.

The critics of attempted U.S. embargoes and economic sanctions against the U.S.S.R. stress, and I believe stress correctly, the difficulty of such policies when undertaken by the United States alone. The history of the last several years whether we look at President Carter's grain embargo or President Reagan's embargo on technology show that our allies did not support these denial measures rendering them ineffective. One concludes, therefore, that embargoes and sanctions could be successful only if Western allies and Japan were to act in concert and, since this is not very likely, embargoes and sanctions should be excluded from various policy options open to the U.S. Government.

Without denying the validity of this argument I just would like to raise one issue. I do not think the reluctance of our allies to support U.S. policies should be taken as a constant. A country's readiness to engage in economic sanctions against another country depends on the cost of these sanctions to the country initiating them and the expected vulnerability of the target country. One of my conclusions is that we—meaning both government and academic analysts—do not have a complete and a comprehensive picture of the Soviet dependence on imports. Support that in fact the U.S.S.R. is critically dependent on trade with the West. Would it not be possible that our allies would view the sanctions proposed by the United States differently?

In this connection I would like to bring up one development in the history of East-West commercial relations that, although not an exact parallel to the present, is quite instructive.

In the early 1960's the Soviet Union and other CMEA countries began to explore the possibility of obtaining long term credits in the West. The response of different Western nations was mixed, with the United States in a firm opposition. Just as these issues were debated in various Western capitals the Central Intelligence Agency published a report on the state of the Soviet economy. Among other things the CIA analysts have concluded that the annual Soviet gold production and the gold reserve was less than half of what was generally believed by Western specialists at that time. The CIA report was met with skepticism by West European and many American academics and the U.S. Government was accused of ulterior motives in releasing the report.

The decision to extend long term credit to the U.S.S.R. made by several West European nations was based on a number of considerations such as the benefits to be derived from expanded trade, reductions in international tensions and the like. However, the rejection of CIA figures and the continuing firm belief that the U.S.S.R. has a large gold reserve estimated at that time at about $7-10 billion must have played a role.

By the early 1970's most of the skeptics came to accept lower CIA estimates of Soviet gold reserves but by that time the détente was in full swing and the issue of Soviet gold did not seem important.

Today we are pondering the implications of the net hard-currency debt of the U.S.S.R. and the six CMEA countries of some $66 billion and the possibility of default by one or several of these countries while the Soviet "gold umbrella" of about $24 billion (roughly estimates at $400 per oz.) is clearly insufficient to cover this debt.

I am not suggesting that the decision to extend long term credits to the U.S.S.R. and CMEA made by Western nations in the 1960's was necessarily wrong. The potential benefits of reduced world tensions were attractive enough to at least seriously consider expanding East-West trade based on credits. Nevertheless, it would have been better were the CIA estimates considered seriously (as they were 6-7 years later) as this probably would have somewhat restrained West European lending to the Soviet bloc.

Much more research into the various issues of East-West economic relations is required at this point. But I do not believe that the possibility of successful economic sanctions against the U.S.S.R. and CMEA nations should be dismissed in the light of available evidence.

6. Research Agenda for the Future.—Except of Soviet arms sales we have a fairly reliable data on commodity structure and country by country structure of Soviet exports and imports. These data, however, are expressed in external prices and cannot be related in internal Soviet flows of production and consumption.

The first research priority, without doubt, calls for estimation of appropriate conversion coefficients and recalculations of the commodity and country trade data in domestic values.

An equally important research task should focus on estimation of direct and indirect trade links of the U.S.S.R. with Western and Japanese markets, i.e. we have to go beyond direct Soviet imports from the West and estimate the levels of Western technologies and other intermediate goods "embodied" in Soviet imports from other CMEA countries.

Having accomplished these tasks we should be in a position to obtain the true picture of dependency of different Soviet productive activities on Western trade by means of input-output techniques.

Moderator Hardt. Thank you.

There are some interesting parallel events related to the period of 1964 that come to mind. One is the succession that was going on at that particular time. Another is the acknowledgement both in the Soviet Union and the West that economic problems were very serious, and at that time there were discussions of reform. In fact, Agenbegian wrote an article in 1964 calling for economic reform and he went then to Novosibirsk I believe and prospered there. There was an Italian publication of his article at that time. So there are certain similarities in the time period which raise interesting questions as to what guidance his careful references give us to current developments.

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1978 to 1980 and has served as a Foreign Service Officer in our Embassy in Moscow.

As was mentioned this morning, he was in Moscow with the United States/U.S.S.R. Trade and Economic Council at the meeting coinciding with Brezhnev's funeral and also has been very much involved in the development on the Hill of some of the legislation that we were particularly discussing this morning.

STATEMENT OF HON. KEMPTON B. JENKINS, VICE PRESIDENT, ARMCO AND U.S.-U.S.S.R. TRADE AND ECONOMIC COUNCIL, WASHINGTON, D.C.

TRADE POLICY IN U.S.S.R.-U.S.A. RELATIONS

Mr. **Jenkins**. I don't want to take credit for that legislation, John. I was involved in trying to stop it with a notable lack of success. [Laughter.]

Moderator **Hardt**. I noted that he had a white hat on this morning and he is continuing to wear it. [Laughter.]

Mr. **Jenkins**. That is right. [Laughter.]

I found it a little hard when you provided me with a title for my comments and the kinds of things that I should address since we have been talking about all these things all morning and there is very little to disagree with any of the comments of my distinguished colleagues today.

In groping to find something different about trade policy and United States-U.S.S.R. relations I decided to focus on the concept of policy and the role of trade policy within the framework of United States-Soviet relations.

In my modest paper, which I assume was made available this afternoon, I touched on several aspects of that question.

(At this point in the workshop someone came to claim Mr. Marcuss' glasses left on the table.)

Mr. **Jenkins**. Mr. Marcuss now owes me not only for the Stevenson amendment but for his glasses. [Laughter.]

In his absence we can talk about that paper more freely than we could this morning.

Moderator **Hardt**. You will consider the appropriate exchange rate.

Mr. **Jenkins**. Right. [Laughter.]

That is the old problem of symmetry again. [Laughter.]

I would like to take a brief look at the formation of trade policy against the backdrop of the problems we have discussed and discuss how that policy was shaped. I was involved in that process from several different points within the Government over the years, and then talk more about the problems of proportion or symmetry which are inherent in most of the comments we have had today.

Over the years as we have run into crises with the Soviet Union—dating back to my first involvement—in the Hungarian crisis, the Czech crisis, and obviously through Afghanistan and more recently Poland and the earlier Berlin crisis of 1958, each time that the Soviets did something dramatic, we felt a need to respond. Administration officers involved in dealing with the Soviet

Union immediately were sent scurrying off to prepare an inventory of elements in our relationship.

Each time there was much rediscovering of the wheel. There was seldom any effort to learn from what was done in the last inventory exercise. So we would go through all of it again.

The inventories covered a wide range. They were reflected, for example, in some of the actions that were taken by the Carter administration in response to Afghanistan. We would always look at our bilateral relations and catalog such things as the building of the embassies, the number of diplomats on both sides, any political prisoners in the Soviet Union—Gary Powers or the CIA agents who were shot down over Soviet Central Asia. In addition we would consider the Consular Convention.

These are all points of pressure, and in the very unique relationship that we have with Moscow, they are quite significant. They take on disproportionate importance to the overall significance of a crisis such as the Soviet invasion of Czechoslovakia.

Then we also always looked at the trade relationship. The Commerce Department would be asked to lay out the volume of trade, the kinds of things we were trading in, how this compared to overall Western trade and the vulnerable points in the Soviet economy. I doubt that the studies were as scientific as Dr. Treml's, but nonetheless a stab was made at it. We had the computer in recent years print out the various types of things that the Soviets are buying from us and so on.

One striking element that was consistently absent in these inventory exercises was an effort to place a proportionate value on the inventory list items, as opposed to what the Soviet Union had done or was likely to do.

After the Czech invasion I was a member of the State Department task force looking at measures that we could take in preparation for what everybody at that time thought was a very real possibility, that the Brezhnev doctrine would be extended to Yugoslavia and possibly even Austria. We really did have options worked out to deal with the possibility of a Soviet move into Yugoslavia, and/or the reoccupation of their zone of Austria.

The Austrian peace treaty under which Soviet troops were withdrawn has some rather ambiguous terms in it, and while we may not take that threat seriously today, I can assure you the Austrians took it very damn seriously in 1968. So this was not an empty exercise.

But as we looked at these issues we would be looking at things like a cutoff of negotiations on the Consular Convention, whereas on the Soviet side we had had a massive historic, brutal invasion of a foreign country. Rarely in my experience have we ever, in running down the options, respected the need for symmetry of response.

There was recognition that we cannot move militarily into Czechoslovakia, but there was reluctance to look at other moves we could take in the military sphere.

I recall that we were pushing very hard for building up our contribution to NATO in response to Czechoslovakia. While that got absolutely no place, there was a lot of concentration on the Consular Convention and cultural ties.

Let me give another example before I get into Afghanistan, and that is the Shcharansky case, an instance where the President ill-advisedly put his personal prestige on the line in support of efforts to block the Soviets from arresting Mr. Shcharansky as a spy.

As a result of the engagement of his personal prestige, there was a decision in the NSC [National Security Council] and the White House that some action had to be taken. The President could not be so embarrassed. Thus, we were instructed at the Commerce Department to suspend the export license for a Dresser drill bit plant, and a lawsuit started its way. Dresser had its lawyers working on it and it cost them several million dollars. Here we are involved with the arrest of one person, a Soviet citizen by the Soviet Government, no doubt on hoked up charges. Yet it is clearly beyond the outreach of American power to influence something like that when it is not even an American citizen that is involved.

The second action taken by the NSC—which has had a long-lasting effect—was to place oil and gas equipment on the embargo list requiring a license for sale to the U.S.S.R. Heretofore oil and gas equipment, because it is readily available throughout the world and has no military application in the direct sense, required only a G-DEST, or a open-ended export license. Placing this equipment under a license requirement and the action against Dresser was the response to Shcharansky.

Now again, I think any reasonable person would see a tremendous disparity in the proportion of the response, whether it was made essentially for domestic political purposes.

In the reaction to Afghanistan the picture was tilted the other way, but equally disproportionate. There were a number of White House meetings about the Afghan crisis and much discussion. The inventory exercise was called for again, everything was listed, and drawing from the inventory, the President made a decision to impose a grain embargo which seemed significant. It certainly had a very heavy cost to the United States. In this instance the lack of cost-effectiveness testing was apparent.

Carter also drew on the inventory for such things as reducing Aeroflot flights to the United States from three to two a week, canceled plans to open our consulate in Kiev—which Dimitri referred to this morning—and the Soviet consulate in New York.

The net effect of that latter act, as Dimitri touched on this morning, was to make it essential for anybody seeking a Soviet visa to come to Washington to the Embassy, instead of being able to get it in New York. Now that can be an inconvenience to Americans wishing to go to the Soviet Union.

We had been working in the Office of Soviet Affairs in Washington for 30 years to try and expand the American presence in the Soviet Union. Those of you who have traveled or lived in the Soviet Union know that in that closed society the presence of an American consulate, particularly in an out-of-Moscow city like Kiev has tremendous political significance.

I don't suggest that Dimitri's reference to intelligence is the answer. It is much more than that. It is intelligence in the very hard broad sense of the term. Being there stimulates all kinds of activities and all kinds of information and all kinds of contracts. It is difficult for the Soviet Union to handle that. There is a big cost involved for them. The proportionate value of an American consulate in an outlying Soviet city like Kiev is much greater than their consul general in New York. We clearly shot ourselves in the foot by closing the consulates.

Furthermore, the consulates are not a matter of massive significance and pale in comparison to the strategic importance of the Soviet invasion of Afghanistan.

We also undertook a series of other shots at our feet which are pretty bloody. We suspended cultural exchanges. The cultural attaché in Moscow, is a close personal friend of mine. I had dinner with him in Moscow when we were there for the Trade Council session last month. He outlined for me the net effect of that action.

The Soviets continue to mount film festivals in this country and send various cultural groups over here under straight commercial contracts. On the other hand, we have nothing going in the U.S.S.R. Amerika magazine which is a very effective propaganda instrument in a closed society like the Soviet Union, was suspended together with the sale of Soviet Life in the United States. You can't give Soviet Life away in the United States and it is singularly ineffective.

A similar counterproductive action was in the Olympic boycott. This is admittedly a moot point. It certainly did make Soviet citizens angry, and wounded their sense of pride. But once again we punished the wrong people. I don't think that any Soviet that I talked to, and I have talked to a lot of them over the last year about this subject, none of them really felt a sense that they shouldn't have gone into Afghanistan because if they hadn't, the United States would have participated in the Olympics.

These actions were essentially a nonresponse. They look good in the United States, show that the President did something. I am afraid that was the motivation. The one significant action we took was the grain embargo. We have talked about who paid most for that action this morning and I don't think there is much disagreement that it cost the United States much more than it did the U.S.S.R.

There were three major projects which we had underway with the Soviet Union at the time of the Afghan invasion. ARMCO's electrical steel plant in Novolipetsk—approximately a $450 million project, largely Japanese because Eximbank's impotence in this situation required us to get Japanese Eximbank financing and therefore they got 80 percent of the business; it meant roughly $50 million to ARMCO—Sayansk which was a major Alcoa project worth probably hundreds of millions to Alcoa and finally International Harvester's approximately $1 billion project to build a major plant to produce farm agriculture implements.

In all three of these projects the American corporations, International Harvester, Alcoa and ARMCO, had gone to great pains to get approval in principle by the U.S. Government of these projects. In fact, in my role as Deputy Assistant Secretary of Commerce one of my responsibilities was to develop a letter from Secretary Krebs, endorsed by the NSC, approving these projects in principal.

So having taken all steps to insure these long-range commitments, all three corporations went ahead and spent a great deal of money. ARMCO lost a million, too, because of the time lost on the contracts and the preparatory work. I don't know what the other corporations lost, but it was greater in both cases and the projects were never carried out with American participation. But Novolipetsk is moving ahead. Creusot-Loire picked up the contract. They had been competing with us for the contract. The Alcoa contract has gone ahead with Klöckner taking over the major role. The International Harvester has not gone ahead, and it may recapture their contract.

All of these things, it seems to me, raise the problem of proportionality.

Again in the recent Polish crisis we had a range of actions. I think the pipeline sanctions and the extraterritorial outreach effort and the decision not to issue any export licenses or to process any additional export licenses for the Soviet Union affected largely the American firms who were trying to do business with the Soviet Union. They did have that impact.

In addition this administration lifted MFN for Poland, which makes it more difficult for the Poles to repay their debt to Western banks. And, we did suspend the right of the Poles to fish in American waters. They had a quota along with other fishing nations in areas where our fishermen are not traditionally active. Finally, of course, we suspended cultural exchanges with the Poles which has had an effect parallel to our suspending cultural activities with Moscow.

I go through this sad tale because I think it reveals the fact that there has been a proclivity in the last two administrations to ignore symmetry and proportionality when we are trying to respond or retaliate to what seems to be inevitable Soviet misbehavior.

What could we have done?

Foremost in the invasion of Afghanistan, a move of potential strategic and even historic significance, obviously the military field is the one that has to be considered. I participated in two White House briefings right after the Afghan invasion, the first as a representative of Secretary Krebs and the second as a representative of ARMCO. These were two back-to-back briefings of the business community about the actions the President was taking in response to Afghanistan. We had Brzezinski, Vance, and the President get up and explain what was going to be done. In a nutshell they said that the President had looked at these options: the political option, namely, protests at the United Nations and withdrawal from the Olympic games; the economic option, trade, the grain embargo and high technology embargo; the military option, which the President decided that would be inappropriate.

One after the other, in both meetings, the opinion leaders who were present would get up and say, Mr. President or Mr. Secretary, I don't understand why if we are confronting something which you describe as the greatest crisis since World War II, we are responding with essentially nitpick actions which impact heavily on American corporations, but very lightly on the Soviet Union.

In each case Secretary Vance responded with a classic non sequitur. The reason for that, we said, is the President decided not to use the military option. The administration's answer was absolute stonewalling. "We are doing what we are doing because the President decided to do it this way."

What could we have done militarily? We can't invade Afghanistan under the present scheme of things. But there were things that could have been done and these businessmen asked Vance and Brzezinski about them: What is the matter with going to Congress and asking them to move on legislation for registration for the draft? Why not build the B-1? How about announcing a determination to establish military bases with the assistance of friendly states in the Persian Gulf area? Why not an objective which will leave us stronger militarily after the invasion of Afghanistan, than that invasion leaves the Soviet Union? What about the propaganda area, why don't we double broadcasts on Radio Liberty to Central Asia, and why don't we increase broadcasts on Radio Free Europe?

Those are things which clearly in their judgment, and I think they are right, would have had an effect on Soviet decisionmakers.

I guess where I come out is that when we are looking at trade policy in the context of United States-Soviet relations proportionality and symmetry are terribly important. We have to have a range in our inventory that goes beyond the lists that we have relied on in the past and I think military actions have to be at the top of the list. That includes a whole range of things: NATO military maneuvers on the Yugoslav border; stepping up military sales to Austria, signing agreements with the Yugoslavs to provide more military equipment, NATO fleet maneuvers in the North Atlantic, U.S. fleet movements in the Persian Gulf, et cetera.

There is value in looking at credit policy. There was a very interesting discussion of it today and I think everybody appreciates just how illusive and complicated credit policy is. The fact is there is a process in the Western world of trying to standardize or to somehow come to common definitions or credit questions. Finally, there is a basic need to develop a consensus on East-West trade.

Redeveloping the consensus, Secretary Shultz clearly is embarked in that process now. I know of no official in the U.S. Government in the 30 years I served in the Government better qualified to understand all of the ramifications of trade than Shultz. I am optimistic that he will be successful in moving that process forward. I think it is also important to recognize that it is a process we are considering. We will never persuade the French to look at anything exactly the way we do including trade. The rest of our important NATO allies, Western allies, are only slightly less "difficult."

But it is important to have a dialog. It is important to have a common denominator and to have agreement on what we can do together. I think it is clear that in the credit field it is in everybody's interest to standardize to a certain degree and we have to make a lot more progress in that regard.

I think it is important to recognize within this consensus that trade has an extremely marginal negative value, but can be useful in a positive sense.

The figures which I think are generally accepted, is that approximately 1½ to 2 percent of Soviet imports from the West come from the United States, which gives you some idea of the dimension of the impact that we can have.

I do dispute the suggestion that there are certain products in which we have a monopoly. Almost without exception everything we produce, and this is particularly true in oil drilling equipment and processes where ARMCO is the world leader. There are alternative supply services. This is an area which Brzezinski and others have long felt was a neuralgic point in the Soviet economy which we could squeeze. I do not agree.

Other countries already have the process and the capability to manufacture or they have the capability to move into that field if it is clear that we are not going to remain competitive. If the financial incentive is provided for them to invest to create the capacity to produce those elements, they will do it. We have seen that in pipelayers with Komatsu and Caterpillar, and we have seen it in the oil drilling field with the French, the Austrians and the Finns, who are all major producers of oil drilling equipment to a certain extent because of the incentives which we created with our embargo actions.

It is also important in developing a consensus within the West that we come to some broad agreement as to what we mean when we say high technology. Now that is a heck of a requirement, and we probably even at this table, even though everybody seems to agree with everybody else on most things, couldn't agree on what we mean by high technology.

From the conversations I have had with people who are involved with high technology, I can see why it is so difficult. In things like computers it behooves the bureaucrat, of which I was one, to be extremely humble in trying to define what constitutes high technology.

The most meaningful characterization which I have ever heard was by a CEO of a major computer firm who said don't try to understand why computers work or even what they do. Just remember that the technology in the computer world is a fast-moving stream, and to take a slice out of that stream and say OK this is high technology is to ignore the dynamic moving nature of the stream.

The fact is the stream is always moving and the important thing is our position in that stream. We want to be at the front end of that stream and we would like to have the Soviet Union be back near the rear, which is where they very definitely are.

They can upgrade their capacity in certain types of computers by buying something which is at the end of our stream and at the top of their stream. And I don't recommend that we rush out and sell the Soviets 10-year-old computer technology and help them make their military more efficient. But the complexity in trying to define what high technology is all about is awe-inspiring. Is it a process? Is it a thought process? Is it a blueprint? Is it a plant to manufacture things or is it the product itself, or is it all of those things? If you license high technology, if you license the thought process as we have done all over the world, how do we pretend to control the product or even the applicator of the process?

The fact is that high technology is fungible, just as grain is fungible and money is fungible. Unless you have a consensus in the industrial world it is impossible to control the export and the movement of that technology in the world. We have learned that lesson in very painful ways from our sales of technology to Japan after World War II where we now find the Japanese using American technology which we sold now being used by the Brazilians to produce high quality steel, which they sell in our market. We can't compete with it because they have newer equipment and cheaper labor. This fungibility is a key and immeasurable element in weaponry "high technology."

I do feel on balance that we have acted or reacted as poorly as we have because of a poor Presidential leadership essentially reacting to a domestic political need instead of really trying to have an effect on the Soviet Union and Soviet policymakers. I am concerned about that because I think not only does it cost our economy and cost our political fabric, but the more important cost in the long run is the credibility of the United States in the eyes of Soviet policymakers.

If we are consistently unwilling to bite the bullet and to make sacrifices to act in the defense field in the face of Soviet military actions, we are not going to be very persuasive when we warn the Soviets not to invade Poland.

I think having said that, there are some things that we can be looking at which are concrete and which are worthwhile and have been discussed to a certain extent this morning.

Some of those issues which are fundamental include energy policy which was touched on this morning. Again, having participated in this debate within the Government and also without, I have been discouraged and even depressed by the level of the debate and the ability, particularly of this administration to turn out one argument and one explanation after another to confuse the Soviets.

Arguments in favor of trying to inhibit Soviet energy development are almost as numerous as our basing modes for the MX. We insist that we cannot have the Soviets successfully build a gas pipeline to the West because we will make the West dependent upon Soviet energy. Then we go through all the figures and statistics and the testimony from our Western allies and find out that at a maximum we are talking about 6- or 7-percent gas dependence for the Germans, for example, ignoring the Western alternative grid system, the ability to switch from one source to another and, more importantly, ignoring the fact that interdependence runs both ways.

I think Ed made the point in his remarks that the Soviet Union is somewhere around 78 percent dependent on energy sales to the West to generate hard currency. Anybody who knows anything about Soviet economic planning realizes that hard currency is perhaps the most neuralgic point in their entire planning process. So who is dependent upon whom?

The Soviets are selling natural gas to the West to generate part of the hard currency which is diminishing as the CIA's estimate becomes increasingly true in terms of diminishing growth in their oil production. Somewhere around the present level of energy earning is the Soviet objective over the next 5 years with gas sales increasing synchronizing in as their oil sales drop off. That still leaves them heavily dependent on Western earnings from those energy sales in the West and the West only marginally dependent upon the Soviet Union for those same supplies.

There is some dependence. There is no question about it. But on balance I think that Soviet dependence is much greater and more valuable and more exploitable in the final analysis.

The cost benefit test is a terribly important concept which has been totally ignored by this administration and the previous administration. I went to Moscow with a number of major grain exporters and Senator Dole and others who are very interested and involved in the impact on the U.S. agricultural sector of any actions in terms of a grain embargo. They continue to insist that the overall economic effect of the grain embargo on the United States is into the tens of billions of dollars and continuing to increase.

They cite the fact that the dramatic impact on a delicately balanced infrastructure which was already in some trouble because of world grain production patterns and some overextension in some cases has had a tremendous impact on individual corporations like International Harvester, John Deere, Massey-Ferguson, and Caterpillar. It has had a tremendous impact on the whole range of agricultural banking in the Middle West and in the Grain Belt areas on the assignment, production, and repair of, rail cars for carrying grain, the grain silo business, the business at the seaports and the infrastructure for getting the grain from the storage bins down to the ports and finally on the shipping business itself.

Now that is a very heavy price. In exchange for that, we enhanced the Argentines as a major grain trader in international grain sales all over the world, just as the soybean embargo against Japan led to the establishment of a major soybean industry in Brazil run by the Japanese and invested in by the Japanese. Today Archer Daniels, the No. 1 soybean exporter in the United States, faces major Brazilian competition around the world which never would have developed, in their judgment, had the embargo not occurred and led the Japanese to make that investment.

The cost benefit test must be applied as we inventory the actions we could take. We have to measure the effect on the Soviet Union and the effect on the United States, our Western allies, the Alliance per se.

Today we are looking at the Export Administration Act. There are a number of things which could occur in the Export Administration Act in terms of reform which would reduce the possibility of repeating the unwise actions we have taken in the past.

The Export Administration Act—Stan was one of the drafters of it when he was in Senator Stevenson's office, and he was the administrator of it when he was at the Commerce Department—includes a number of important loopholes which have enabled some of the actions most importantly under foreign policy control section.

We have talked about that quite a bit this morning, or we have danced around it quite a bit. My strong recommendation is to abolish foreign policy controls.

Even Larry Brady when he first returned as Assistant Secretary of Commerce publicly stated at the Chamber of Commerce that foreign policy controls should be abolished to put predictability back into America's trade position. I haven't heard Larry say that lately, but he is on the record. [Laughter.]

I don't think that that is a bad thing and I don't think that that would inhibit the President from doing the things that he has to be able to do.

As John can assure you, I believe strongly in a strong executive branch with a minimum of congressional control, and I am not in favor of denuding the President of the capacity to respond to international crises. I don't think we have to do that.

The fact is that if a crisis is serious enough for a President to invoke foreign policy controls, he can go to Congress and take action with congressional support at the same time that he is consulting with our allies, which he should be doing anyhow, and with the exception of the Brzezinski administration, we usually have done.

A foreign policy control can be developed, if the crisis is of significant proportion. The President won't have trouble getting congressional support to place a grain embargo, if our allies are going to participate and if the people of the United States think the crisis is that serious.

Anything short of removing foreign policy controls in the Export Administration Act has to leave the President, in the final analysis with an out, a phrase to the effect that unless conditions are so serious that it requires immediate action, et cetera, et cetera, after which he is required to notify Congress and inform them.

Stan pointed out this morning that the Presidential justification for the sanctions on the oil pipeline required under the law has just been received by Congress, even though they have already been lifted. That is a violation of the law. But what can one do about it in practical terms.

It does demonstrate the impotence of a congressional restraint in a situation like the Polish crisis where everybody clearly wanted to do something. Because the President had that flexibility under the foreign policy controls he was able to ignore the requirement of the law.

Foreign policy controls should be abolished. I think extraterritoriality should be prohibited. It clearly is so damaging to the fabric of our alliance which, after all, is the overriding strategic advantage which we have over the Soviet Union. Our allies are on our side and theirs aren't.

To resort to extraterritoriality, which under international law and tradition is illegal and unethical in terms of behavior between allies, is so costly that we need a specific inhibition in the Export Administration Act against it.

The discussion of insurance was quite interesting and it would be nice, but again I sat through a number of discussions within the Government and I think Gary did, too, where we talked about compensation for the grain embargo and compensation for other things.

An effort was made to compensate in terms of grain allocations so that the farmers wouldn't have to bear quite so much of the brunt of the embargo, but the real cost of the embargo was not in the immediate sale of a bushel of wheat. It was the infrastructural cost, and insurance is irrelevant in that situation.

Discussions about insurance for Dresser, for Ingersoll-Rand, for example, quickly became unrealistic because of the impossibility of determining the real cost. The congressional attitudes on this sort of thing were so negative that nobody ever discussed it any further.

My own judgment is that any discussion of insurance is essentially wasted effort. I think what we need to do is make sure that when we take actions that are sufficiently well planned and soundly based that insurance is not necessary.

Finally I think the sanctity of contracts is an absolutely essential concept. The President, bless him, said that in Iowa. We won't look into his motives for saying it there at the time, and he was referring only to the agricultural sector, but it is on the record and I like the ring of it. I think it ought to be in the Export Administration Act.

It would be a terribly important contribution to the predictability and capacity of American corporations making decisions about investments, and it would do a great deal to minimize the cost to the reputation of American business as a reliable supplier.

I think, John, that is where I would like to stop. That is not exactly what I said in the paper.

[Mr. Jenkins' prepared statement follows:]

PREPARED STATEMENT OF HON. KEMPTON B. JENKINS

A discussion of trade in United States-U.S.S.R. relations must provide at least an appreciation of its relative significance within the full complex fabric of those relations. This prerequisite has all too often been lacking in policy considerations within our government. In the recurring crises with Moscow since World War II the instinctive response in Washington has been to "inventory" the elements in our relations. This occurred in each crisis: The Berlin blockade, the Hungarian uprising, the Berlin access crisis, the Cuban missile crisis, the Czech uprising, Afghanistan * * * As a political officer in Berlin and Moscow, a Soviet Affairs desk officer, Assistant Director of USIA, Deputy Assistant Secretary of State and Commerce, I participated in these recurring "inventory exercises." Almost invariably the actions chosen from the inventories ignored the relative significance of the individual pieces in the overall fabric of United States-Soviet relations. To put it another way, rarely did they take account of the relative importance of the individual piece to the overall Soviet scheme of things. This perhaps explains best the futility and impotence of U.S. responses to Soviet misbehavior; recall President Carter's reduction of Aeroflot flights to the United States from 3 to 2 per week in response to the Soviet invasion of Afghanistan.

At the risk of being elementary, let's run down the scale of elements in the United States-Soviet relationship:

1. Arms control/balance of power.

The overriding and clearly dominant significance of this aspect of our relations dwarfs all others. Success would render all problems manageable and failure leave them irrelevant. (It is not encouraging that the U.S. Government institutional dedication to arms control is in such disarray—ACDA remains without number 2 and 3 men after 2 years of the Reagan presidency, thanks to the disproportionate influence of a handful of extreme right-wing Senators!)

2. International political struggle.

The continuing turf battle with Moscow ebbs and flows in a rapidly shifting geographic arena. On balance, since World War II Soviet influence has lost ground. China, Egypt, Indonesia, Ghana, certainly outweigh IndoChina, Ethiopia, Cuba, North Yemen. But this political warfare remains vitally important to both sides—a way to compete short of nuclear war. A key sub-ingredient in this struggle is the global propaganda contest between us for world influence, especially the radio war with our VOA Radio Liberty and Radio Free Europe often outpowered by Radio Moscow.

3. Economic competition.

The contest between the Western economies and Moscow's centrally driven economic development program has invariably seen the West in front. Moscow's dismal performance has elevated this in importance in Soviet policy councils, but the uninterrupted growth of the Soviet military budget and continuing massive aid programs for Soviet satellites, irrespective of the state of the domestic economy, reflect Moscow's clear priority evaluation.

4. United States-Soviet trade, constituting 1.5 percent of 1981 Soviet imports, obviously is but a sub-point in the economic contest between us, which in turn is heavily outranked by the arms contest and the political struggle.

5. The United States has even unwittingly contributed to further diminishing the importance of trade by introducing irrelevant elements such as the Jackson-Vanik amendment. By tying Soviet treatment of its citizens to our trade negotiations, rather than increasing emigration of Soviet Jews, we squelched growing trade and reduced emigration in the process.

So—where does trade stand in the overall relationship with Moscow? Clearly very low on Moscow's list, but disproportionately valued in Washington. This disparity reflects the cold reality that the White House feeling that "something must be done" even when nothing substantive can be, has seized on trade from the inventory list. This has been done without any appreciation of its cost to the United States relative to its effect on Moscow.

My allotted subject, Trade Policy In United States-U.S.S.R. Relations, as I interpret it calls for a discussion of the role of trade within the overall panoply of the relationship between Moscow and Washington.

1. The track record.—United States-Soviet trade was virtually non-existent until the middle seventies. Trade figures totaled less than $100 million year after year. The trade consisted of such things as the purchase of furs and vodka on the one hand, and the sale of agricultural implements in the other direction. Beginning with Krushchev's ascension to power in Moscow, United States-Soviet trade experienced the dynamism of Khrushchev's erratic but growing involvement in the rest of the world, until at the height of détente, trade totaled over $4 billion in both directions; Small compared to Mexico, Europe and Japan but nonetheless significant both in economic and political terms. U.S. Department of Commerce estimates spoke of a potential $10 billion level, largely in favor of U.S. exports. In 1980 the shock waves caused by the Soviet invasion of Afghanistan and the subsequent crisis in Poland quickly resulted in a cutback to under $2 billion. Today the trend is up again but slowly. In short, the level of trade between our two countries has directly reflected the state of our political relationship—for businessmen a frustrating reality and a distinct disincentive to investing the time and money necessary to do business with the cumbersome Soviet system.

2. The limitations.—One of the basic causes for the erratic and frequently counterproductive U.S. policy toward trade with the Soviet Union has been failure to recognize the limited significance of United States-Soviet trade to both partners. Last year Soviet purchases from the United States constituted less than one and one half percent of their imports. True, some of those products were of considerable importance but fundamentally the dimensions of the United States-Soviet trade instrument can be seen to be very small indeed. There is very modest potential in the trade relationship between Moscow and Washington to affect fundamental Soviet national interests and internal security concerns.

3. Capabilities.—If trade is so small and limited what is its value? Trade with the Soviet Union has historically been very profitable for the corporations engaged in it, has been of a long term predictable nature (if you rule out U.S. political responses to Soviet activities), has provided widespread contacts with the Soviet management class, and made a significant contribution to opening up the closed nature of Soviet society. In short, it is a positive factor but only on the margin. To quote Henry Kissinger "We did not believe that trade itself could moderate Soviet conduct. Our basic reliance was on resisting Soviet adventures and maintaining the global balance of power; economic incentives could not substitute for equilibrium. We believed however that Soviet restraint would be more solidly based if reinforced by positive inducements including East-West trade."

4. The fraternity of managers.—In the long term the United States has two alternative paths to reduce the threat which Soviet power poses to the Western world. Contain and defeat it by overthrowing the present power structure, or contain and moderate it. If you accept the latter as the only realistic course in a nuclear age as I do, the managers within the Soviet system (who number hundreds of thousands) who have a strong vested interest in a rational economic relationship with the outside world and a compelling need to make their system work, are the most logical hope to bring about greater moderation in Soviet behavior. Soviet managers recognize the economic interdependence of today's world. They seek a greater share of Soviet resources and whether witting or not, are a force for reducing arms expenditures and the contained absorption of the Soviet systems best technicians into the military sector.

5. The dangers of unilateral policy.—Since World War II there has never been a sustained and successful development of consensus about trade with Moscow. In the absence of a philosophical consensus on this contentious issue, each time political crises have arisen, the United States has attempted to pressure our allies to introduce punitive trade measures against the Soviet Union. Without exception these efforts in the post war years have failed. They have increased divisions within the alliance, reduced the possibility of achieving other U.S. foreign policy alliance objectives, persuaded Moscow that the NATO alliance is something of a paper tiger in terms of economic sanctions and perhaps even lacks the will power to take stronger measures which would be effective.

In closing, I would like to make two or three points. U.S. economic trade ties do not exist in a vacuum. Economic or trade relationships are global and highly fungible. Any trade policy changes designed to accomplish political changes in the Soviet Union must meet available supply source tests. Since this is highly unlikely, we should recognize from the beginning the use of trade for political objectives is a most unlikely instrument. Secondly, any efforts in the trade policy field toward the Soviet Union whether positive or negative, should meet the cost-benefit test. In this administration the United States has focused almost solely on national security considerations, ignoring the economic cost to American corporations and the political costs to our alliance. All three of these things are clearly relevant. Above all we should accept the fact that trade has but a modest positive potential in United States-Soviet relations; capable of improving the atmosphere, generating some business and contribution to the long range objectives of advancing rational sophisticated managers within the political structure of the Soviet Union. As a negative instrument it is without merit.

In the United States, trade has been seized on as "something we can do" with depressing regularity. It has been designed essentially to demonstrate to the American people that the President is not standing by idly. My concern is that for this domestic, political purpose, we are paying a long term political cost in alliance politics and in undermining the credibility of the United States in the eyes of Soviet policymakers.

Moderator **Hardt**. As Professor Treml is going to be leaving first because of some transportation commitments, let me initiate the discussion by asking him to comment further on a couple of points.

One has to do with the question of the relationship of foreign trade within the CMEA and with the Western countries. As Jan pointed out, the Soviets may be pressing the East Europeans to produce more machinery.

Mr. **Vanous**. Not pressing. The East Europeans want to sell more machinery.

Moderator **Hardt**. Well, there may be an option, let's put it that way, of increasing the reliance on Eastern Europe. To what extent are these alternative ways of dealing with the machinery question and to what extent is this an option that poses difficulty for the Soviet Union because of the impact it may have on the East European development?

In other words, the initial question is to what extent is your assessment differentiated according to the CMEA versus Western sources of imports.

The related question is in terms of your assessment of the importance of trade. It seems to me that your approach focused more on benefits and opportunity costs and timeliness. By this approach you came out with a higher assessment than by looking at it from the standpoint of the value in the world market.

Is that a credible distinction?

Perhaps you could comment.

Mr. **Treml**. John, you know I had a section which I skipped simply for the sake of time. None of my work or our work at Commerce really distinguishes trade by blocs and for two reasons. One is it is a very time-consuming effort and no one has undertaken it yet. Since we prefer to work with domestic rubles, we cannot break out the trade in domestic rubles into Soviet Hungarian or Soviet Polish, or Soviet Union. Just as one example, with respect to what Mr. Jenkins said, 1½ to 2 percent U.S. trade.

In the larger sense I would like to see a different number. I would like to see the percent of U.S. imports and Soviet imports in domestic rubles and this percentage could possibly drop or it could go up as high as 4 percent. I have been pleading in this town for much more resources devoted to this issue.

Mr. **Jenkins**. The Soviets contended in Moscow 2 weeks ago that 1.2 percent, which I take with a grain of salt because they had a purpose for saying it, but they said in domestic rubles the value of U.S. imports was 1.2 percent of their total Western imports.

Mr. **Treml**. It is here a particularly difficult issue, almost reasonable because they import so much grain and grain is being subsidized.

Mr. **Jenkins**. This was excluding grain.

Mr. **Treml**. So this is one reason. The second reason is that another thing we do not know is, and I believe I am repeating Jan correctly, when he said that Soviets import about 15 billion rubles or dollars, and in this respect it doesn't matter because the conversion rate is one to one, of machinery, two-thirds from CMEA countries and one-third from the West.

What we do not know because we did not spend enough resources studying it, we do not know how much of Western exports of machinery to Eastern Europe ultimately find their way to East Europeans.

I was told by a Hungarian economist, a rather prominent one, that, for instance, the large exports of Hungarian buses to the U.S.S.R. have French and Belgium ball bearings. Dr. Vanous was telling me today, and I have read about this earlier, of a large number of Western radio and other components of Polish ships going to the Soviet Union and Poland is the major supplier.

Moderator **Hardt**. The German Democratic Republic as well.

Mr. **Treml**. Yes; but Poland is No. 1 in supplies of ships. It is purchased for hard currency by Poland. So before we address ourselves to this essential issue of fact, to me division in blocs is meaningless.

When I stress the timeliness and the extremely high marginal value, I was simply saying that we may have to go beyond if in fact today Soviet imports are, say, close to 20 percent of the Soviet net retail product. The true value could be much higher, but going beyond this, these calculations are not included in my percentages.

Moderator **Hardt**. Do you have to leave at this point?

Mr. **Treml**. In 2 or 3 minutes.

Mr. **Scuka**. I don't know if it is only in my imagination, but I have read statistics that in this decade there has been Soviet stability, and it has been roughly 4.2 percent of GNP for our trade and 2.5 is for grain. You have said just the opposite, that the amount of foreign trade has grown.

Moderator **Hardt**. He said the significance.

Mr. **Treml**. Soviet imports in dollars or in rubles or in whatever else you want to measure them in have been growing at several times the rate of the growth of national income for the last 20 years. They have been importing grain varying from 5 million tons to 40 million tons. So commodity by commodity year by year and country by country the trade is not stable, but the Soviet imports have been one of the fastest growing imports in the world since the early 1960's.

Moderator **Hardt**. I think his argument also is that we have undervalued them and that therefore there should be a revaluation based upon the domestic assessment in ruble terms of the value of imports.

Mr. **Treml**. Yes.

Moderator **Hardt**. So your apparent paradox may be resolved by revaluation.

Mr. **Treml**. May I share with you one thing before I go. I just noted that the new Secretary General of the Communist Party is wearing bifocal lenses. The Soviet Union is not producing bifocal or any stigmatic lenses. All of them are imported.

Moderator **Hardt**. What is the foreign supply situation? [Laughter.]

Mr. **Treml**. I don't know, but now we have the Soviet leader who would be blind without imports. This shows really how again, sort of the example of the bifocal, trifocal as I am wearing, and this is not a particularly complex technology, but the choice was made and they do not produce anything but simple——

Mr. **Jenkins**. Certainly the East Germans do.

Mr. **Treml**. Again, it is not state of the art technology. It is simply for one reason or another that they simply decided not to develop certain industries.

Moderator **Hardt**. You mentioned in your oral comments a matrix that you had thought of. If you could include that in your comments. Also, you mentioned earlier a inventory of areas that we should undertake research in to answer some of the differences, and if you would also include that.

Mr. **Treml**. These are quite technical, but I will have the answers.

Moderator **Hardt**. I think that would be helpful and we can turn to our colleagues here who will undoubtedly solve these research problems. [Laughter.]

Thank you very much, Professor Treml. He has to return to Durham. He is not at Commerce full time. He is a professor of economics at Duke University.

I think it might be useful to turn to Jan because some of these questions are relevant to your perception and you, Ed and Jenks, may wish to comment further on the comments of others before we go to the general group.

Mr. **Vanous**. Let me, if I may, just touch once more a little bit on this business of machinery trade.

First of all, it should be recognized that there are two types of machinery which are imported. Some machinery is really an intermediate import and some is final import. Therefore, when you are looking at the importance of imports, you really should be relating it to all demand, including the intermediate demand, because it is not at all clear where each type of machinery falls such as in the case of the ball bearings. These are not final products. It is a component that is embodied in another machine.

I have roughly estimated that the Soviet output of machinery in 1981 is going to be something around 180 billion rubles. According to a Rand estimate, they would value one ruble worth of machinery at something around $2, and I think it is way too much. In view of its poor quality, I prefer to value 1 ruble worth of Soviet machinery at about $1. So I estimate gross output of machinery in the Soviet Union at $180 billion. Then I look at imports, and I was trying to be realistic about the scale of imports from Eastern Europe, but I still come out with only about 8 percent share of imported machinery.

So somehow there seems to be a difference of opinion and perhaps it is fairly technical, but there are some more fundamental questions in this.

One thing that we have been talking here about is what happens if we don't sell the Soviets the machinery they need and other Western European suppliers will. But why are we so concerned about other Western European suppliers? We are building a competitor in East Europe, and I have no doubt that by the mid-1980's they will teach us a lesson in the Soviet market. It is out of sheer necessity that Eastern Europe must do this. When you look at the trade relationship of the Soviet Union with Eastern Europe, during this 5-year period the Soviets are steadily increasing oil prices to Eastern Europe as they are catching up with increases in oil prices on the world market. East European terms of trade are deteriorating at an average rate of 7 percent per year. The Soviets are now insisting on balancing trade. So what does it mean? To keep trade balanced, for the same amount of imported energy, Eastern Europe has to export a lot more goods. The only thing they can sell to the Soviets on a large scale already accounting for around 60 percent of their trade—is machinery.

Moderator **Hardt**. Are you suggesting that in 10 years the East Europeans in a rather general way will become competitive in the world market for machinery?

Mr. **Vanous**. I am referring to the Soviet market. They already are competitive there. If you look at the East Germans, I am sure in many machinery lines they are very competitive, and certainly the Poles are increasingly competitive, and so are the Hungarians in quite a few areas, and to a lesser degree also Czechoslovakia which used to be the foremost competitor.

The fact is that in order to keep the trade between the Soviet Union and Eastern Europe balanced, for every 7 percent deterioration in terms of trade, Eastern Europe will have to increase real exports of machinery to the Soviet Union in excess of 10 percent.

Now looking at the recent path of Soviet foreign exchange earnings, I think that Soviet imports of technology from the West at best will stagnate in real terms during this 5-year period while East European machinery exports to the Soviet Union may increase as much as 50 percent in real terms.

There is a possibility that only some of the decline in the demand for imports from the West is in those areas where the machinery is standardized enough that the East Europeans can come up with decent enough substitutes. There are certainly areas where the West has a considerable production advantage and it is unlikely to be replaced as a supplier, but there will be an increase in the number of products where the West will compete in the Soviet market with the Eastern European economies.

I think that in the long run Eastern Europe is our major competitor and we ought to be asking about the wisdom of our trade policy because some of the steps we are taking are in fact fostering East bloc integration and strengthening of the bloc. I am not saying that they will turn to the Japanese; there is very little chance of that, but they are becoming our competitors in the Soviet market?

Moderator **Hardt**. Is that bad, to be able to pay their debt and also buy——

Mr. **Vanous**. They are not paying their debt, not to us. They are going to be competitors because they need access to Soviet energy. They are going to sell machinery to the Soviet Union and they are going to be competitive with us.

Moderator **Hardt**. In the Soviet machinery market?

Mr. **Vanous**. Yes; in the Soviet machinery market. I think that is where the competition is going to come from in the years to come. Certainly the East Europeans will be selling their machinery heavily to the Soviets. That is where the imports are going to come from and not from the West.

Mr. **Jenkins**. It is interesting, John, at the last meeting we had with the U.S.-Polish Trade Commission in Warsaw we had a General Motors representative there and we discovered at the meeting that all of the truck transmissions in the British trucks, the General Motors British trucks were in fact built in Poland because the quality was better, the price was better and the supply was more dependable.

Moderator **Hardt**. Is the supply still dependable?

Mr. **Jenkins**. I don't know what it is now. This was 5 years ago.

Mr. **Vanous**. The French truck axles are now being built in East Germany.

Mr. **Jenkins**. It shows a capability, at any rate, to produce something fairly sophisticated. I have never ridden in a British truck, but the fact is they were successfully marketing through an arrangement they had with Poland of putting a fairly complicated piece of machinery into a Western product.

Moderator **Hardt**. Let me pose another general question that applies to both Ed and Kempton Jenkins. We talked a good deal about the cost-benefit approach and the history of denial in its short-term or crisis management aspects, and we have also been talking about long-term relationships, for example, in terms of the combine or the equipment sales, the questions of developing the steel plants and so forth.

To what extent is there a requirement for different approaches to these short to longer term aspects? And what about the need for both carrot/stick and stick/carrot approaches? Did I make myself clear?

Mr. **Hewett**. I didn't quite understand the question.

Mr. **Jenkins**. I think, if I understand you, you are suggesting that one of the problems we may have had is because we have been looking at things strictly in a short-term focus.

Moderator **Hardt**. Our history, as you recounted it, is a short-term denial history.

Mr. **Jenkins**. That is true.

Moderator **Hardt**. The problems that Ed identified are short-term denial problems. The potential, if you look at the Soviet economy, is in long-term benefits. So if we want to have influence, doesn't it follow then that we go through a long-term benefit approach and a variation of the benefit approach in order to maximize our influence?

Mr. **Jenkins**. My answer to that would clearly be yes. That is the short answer.

Mr. **Scuka**. But you deny the use of embargoes.

Mr. **Jenkins**. Deny the use of what?

Mr. **Scuka**. Of embargoes in the process of working toward long-term benefits in foreign relations.

Moderator **Hardt**. Well, that is the question. Can you orchestrate long- and short-term policy?

Mr. **Scuka**. I think Ed made a convincing case for that.

Mr. **Vanous**. You could presumably identify a well-defined set of circumstances enough in advance of when you will use the embargoes.

Mr. **Jenkins**. From a policy point of view I think that most of my colleagues in the State Department have always felt that if we can develop our economic relationship and promote interdependence as opposed to discouraging it, that we can, in fact, make serious progress toward bringing the Soviet Union into the civilized world and to a state of eventual genuine coexistence, not in the Khrushchev sense of the term, but that only through a long-range, and it may take 30 years, and there is certainly more than one generation of Soviet leaders to do that, can you really achieve that kind of an objective. Each time you interrupt the process with an embargo you sort of go back to scratch, and that is what I think we have been doing without accomplishing our short-term military or strategic or political goals.

Mr. **Scuka**. John, may I comment on an issue raised this morning.

Moderator **Hardt**. Yes.

Mr. **Scuka**. In the discussions this morning there were crucial distinctions made between foreign trade and foreign investments. I would like to add an historical note concerning the apparent climate in which the present administration, and some previous ones, approached the formulation of foreign policy concerning commercial relations.

Given the cold-war environment in the late forties, through the fifties and most of the sixties, the mainstays of the U.S. foreign policy were considerations based on foreign aid, that is, foreign economic assistance supplemented and/or integrated with military aid. In fact, in 1950, U.S. merchandise exports were about 3.6 percent of our GNP, in 1960 they were 3.9 percent expanding only to 4.3 percent by 1970 but they reached 8.5 percent in 1980. U.S. export trade has thus achieved significance only recently in contrast to most other industrial countries that found exports vital to their economic well being in the whole post World War II period.

In the evolution of the seventies it seemed that American policymakers transferred their systemic foreign policymaking process from a declining foreign economic aid to an expanding foreign commercial trade in general.

The case of the Soviet Union after 1972, however, presented a unique situation for the United States. There was no foreign economic or military aid in place, and thus any kind of leverage was absent. Political considerations suddenly pressed into duty, as a surrogate to foreign aid; new commercial relations developed between the United States and the Soviet Union with results that we are familiar with.

From an economic analytical viewpoint, any economist that rides foreign commercial trade with the same saddle used for foreign aid soon discovers that one may be a horse, but the other one may be a camel.

A personal analytical consideration that I have followed through my professional life is to recognize that foreign trade takes place because of mutual benefits but not necessarily equal benefits, and this is one of the things that most policymakers seem to disregard. They appear to think that the relative value of exports and imports is measurable on a one-to-one basis. Experience has shown that that is not the case among goods or countries.

Moderator **HARDT**. Would you like to translate horses into missiles, Ed, so that we can keep our metaphors straight? [Laughter.]

Mr. **HEWETT**. Basing camels is easier than basing missiles. [Laughter.]

Mr. **LOSMAN**. I am sorry that Dr. Treml had to leave, but let me throw a question out for the panel. What we have talked about essentially this morning is the great cost to our own economy and the political costs as well by imposing these short-term trade interruptions. So we conclude that there is a great deal of cost, yet the benefits are very mushy, and as Dr. Hewett pointed out, we use these economic tools to achieve political or strategic ends.

But maybe rather than comparing our costs to their costs, in a strategic sense you might want to look at the margin of "fat," in a sense, in their economy versus our economy. I am just hypothesizing now. I haven't heard anyone say today that there were no costs imposed upon the Soviet Union. There was obviously a difference of opinion, I think, between two gentlemen on the panel as to Dr. Treml's suggestion that there was a greater impact involved and more cost.

Would it be worthwhile to try to compare cost with the margin of fat? If our margin were large, say A, and the Soviet margin smaller, D, even though the cost to us, B, exceeded the cost to them, C, if they were having a lot of problems so that costs, C, exceeded their ability to absorb, they might have to undertake radical changes like cutting military spending or loosen up control. Despite the larger absolute cost to us, it might still pay to impose sanctions. If indeed the Soviet Union were in a squeeze and they in turn had to squeeze their colleagues in Eastern Europe, whose terms of trade will worsen? Maybe from a strategic view there is still some merit in economic measures?

Can I have your opinions?

Did I make myself clear?

Mr. HEWETT. What you really are arguing is that even a minor impact on the Soviet economy could be enormously important. There are certain people who will tell you that the Soviets are close to the margin, but I am not one of them. I think one of the dangers of regaling ourselves with umpteen stories about the increasing foreign dependence of the Soviet economy is that in everyone's mind there is an implication, that this is an economy which is increasingly sensitive to manipulation by the United States or by the United States and its allies. That is a leap of faith which is not justified.

What you see in the Soviet economy is a rational decision beginning in the sixties to capture some of the potential gains from trade through specialization and trade, a very sensible thing to do. As a result, real trade—real imports and exports—grew much faster than national income and probably will for a good long time. Yet, they are still, as Jan pointed out, far less dependent on trade than other countries at their level of development.

More directly responsive to your question, I would say that for the measure which we, the United States could conceivably take against the Soviet economy would have such a minuscule impact. The embargo is an excellent example because there the United States was using some of the best levers available to it in the economic realm.

There must have been some negative impact on the Soviets from the embargo at least in the engineering of those pipelines. When engineers are planning compressor stations, they don't simply say "tell me what kind of turbine will be coming and we will plug them in." Those compressor stations must be redesigned depending upon what sorts of turbines and compressors are being used.

We may have slowed down that program. On the other hand we certainly sped up turbine development in the Soviet Union, by at least 6 months. We did something for them in our relations with Western Europe that they could never have hoped to have done. If someone in the Ministry of Foreign Affairs sitting around for the New Year's Eve discussion in 1981 said this is what I want to do, they would have kicked the kid out and said he is young, he is inexperienced and he doesn't know what is possible. But we did and they didn't have to lift a finger.

It is not clear that the net costs to the Soviet Union of the embargo were negative. I think you could construe this as a case where they received foreign policy benefits. The costs they incurred were relatively small. This is an economy that has had positive growth rates every year in the postwar period and it is still turning in 1 to 2 percent GNP growth rates now. We can't say that.

It is an economy that is enormously strong with the strongest resource endowments and fuel endowments of any industrial country in the world and they are not stupid. They are using those endowments in ways that are relatively sensible. They are not brilliant. I disagree with Jan, but we are not brilliant either.

Mr. VANOUS. Did I say that?

Mr. HEWETT. You said that at one point. It was probably a slip. You said they were brilliant. [Laughter.]

I would say that even given the way that they operate in this world——

Moderator **Hardt**. You can edit the record. [Laughter.]

Mr. **Hewett** [continuing]. They have a fair amount of flexibility in that system. If you want to talk about ultimately the amount of fat in the Soviet Union and the amount of fat in the United States, they have probably one of the most tremendous reserves of any industrial country in the world, and that is, the inefficient economic system they use to allocate resources. If they ever decide that they want to begin to reform that system, a decision which they seem to be in the process of making right now, they could have an effect on economic performance far outweighing anything we could ever hope to do. I think, if anything, we may act as a catalyst pushing them in that direction a little bit faster than they would have done on their own.

Dr. **Stent**. A couple of points on Kempton Jenkins' very interesting discussion of symmetry. I think symmetry is impossible. We cannot respond to Soviet actions in kind because we are not that sort of society and we should give up the attempt. What we should do is at least try and respond in such a way that our actions do not hurt ourselves and our allies more than they hurt the Soviets, and one could argue that the pipeline sanctions did precisely that.

Now the other question is—and this is what some Europeans ask—why does the United States feel it has to respond to everything the Soviet Union does? Why is it always in this reactive position? Could we not respond selectively or respond where we think that we have some impact, where our actions will make a difference? Would it not be better to take the initiative sometimes, for instance, in response to your question about what we could do instead of using economic measures. Maybe we could preempt the Soviets in some Third World countries. Maybe we could free our hands a little bit more to give military and economic aid to certain areas in the Third World where the Soviet Union is involved.

My question is, Do you think that such a policy would be salable to the American public or do you think one would have to reeducate them so that we do not always have to be in a position where we have to react to what the Soviets do?

Mr. **Jenkins**. I agree with you, and I think symmetry is probably the wrong word. The dimension is the important thing. Now there has got to be a word that is just right and captures it in one word, but you know what I am talking about. I agree that we have to be free to react in areas where we can draw a price which is at least in some proportion commensurate to the crime they have committed.

Discussions were held, for example, of why don't we blockade Cuba in response to Afghanistan. Now there are a lot of reasons why this may not be such a good idea such as that opens up the possibility of their blockading Berlin which is the historic link between those two places. But the fact is that I am not opposed to that kind of thinking.

I don't think that we have a task to reeducate the American people. I think the American people are miles ahead of the political leadership in this country in responding to a situation like Afghanistan. I don't think any public opinion poll would have found the American public impressed by the steps that we took nor hostile to the idea of President Carter saying, you know, by God, I killed the program, but the Soviets have been so ghastly and so brutal in Afghanistan that I am going back to Congress and ask for funds to build the B-1.

I think the country would have come right out of its chair and applauded him and he might even have gotten reelected. [Laughter.]

Well, maybe not. [Laughter.]

But at any rate, I don't think there is an education problem. I think there is a leadership problem and the same quality which has led some Presidents to take cheap shots instead of substantive steps in response to serious strategic threats is also manifested in an inability to express policy decisions to the American public effectively. I think both of those things are doable and I think our system can handle it, and I think our public can definitely handle it.

Mr. KOHN. One issue that I don't think has been touched upon here this afternoon is the macroeconomic importance of U.S. trade with the Soviet Union. A very strong case has been made that sanctions are ineffectual, a strong case has been made that politically they may have been unwise, and a strong case has been made that individual firms may have suffered and perhaps unfairly. However, Ed was talking about the fact that we can quantify the economic cost of sanctions.

Now our exports to the Soviet Union are still a minuscule portion of our GNP. I would suspect that the serious limitations on Soviet hard currency earning capacity will limit the potential of U.S. exports to the Soviet Union.

I would further say that even under the best of circumstances countries such as West Germany are going to have a huge competitive advantage over the United States.

Therefore, I would at least like to set this in perspective. If the sanctions were wrong, I am submitting that we have not paid a very high economic cost for them, and I would like to hear the views of the panel on that hypothesis.

I agree that individual firms such as your own may have suffered, as I say, unfairly. I don't think that this has been of any macro importance for the United States, nor do I see that there is any great potential for expanding our exports to the Soviet Union given the advantage that other exporters have and given the serious limitations on the Soviet Union's ability to earn the hard currency to expand its imports from the United States.

Moderator HARDT. You would further argue that macromeasures are significant?

Mr. KOHN. I am arguing that in macroeconomic terms it doesn't have any importance.

Mr. HEWETT. I certainly agree. As I say in my paper, the total costs so far, at least the economic costs at the front end have been quite small. For individual firms they have been enormous and for individual sectors they have been enormous. I mean if you look at what is happening in grain exports, that is a real cost for a focused sector of the economy. It is not macroeconomic. It is microeconomic costs.

I would have one caveat though. Because of what we did, what we have said so far, there is a lingering question mark about our position on sanctity of contracts. I have no idea what effect that will have, but I can imagine the situation where firms deciding in the future about technologies and choosing, say, between United States, Japanese, and European technologies will consider this factor in making their purchase decisions.

In areas where we have a decided advantage they will simply have to take the risk. But on the margin it could tip those deals toward European and Japanese technologies. We have no way of measuring that. Deals that weren't made are fairly hard to see, but nevertheless, this is a cost that we cannot just dismiss. That is what I mean by the longer term costs of sanctions.

The President of the United States and the Congress should say that this was a bad idea and we will never do it again. This would not dispell all of the doubts, but without it the doubts will remain. I can't document they remain because I don't know enough about the contracts.

Moderator **HARDT**. There were quite a few examples given this morning by the NAM on that very point.

Mr. **VANOUS**. Yes; there are other examples. What about if the United States chooses a strategy for providing assistance in the Soviet energy sector and a willingness to go along with exporting as much Soviet energy as possible? You might ask the question what this strategy would do to the world energy markets? Would it increase competition? Would it weaken OPEC? What kind of amounts are we talking about? How would the U.S. economy as net energy importer benefit? I mean you could go into hypothetical scenarios, and right now I can imagine that given the extreme instability of the world energy markets, the Soviets could have a noticeable impact; that is, downward push, on the energy prices. That would benefit us at least to the degree that we would have a cheaper energy.

Mr. **ABERNATHY**. I think on the contrary if you have an increased Soviet production of oil, you are going to have a decreased price on the world market which is going to decrease the domestic production of U.S. oil. We will end up helping the Soviets develop their natural resources while our own energy production declines. Then when global resources decrease you will find the Soviets with a well-established infrastructure in place while the U.S. infrastructure has diminished.

Mr. **HEWETT**. So if we are concerned about that put a tariff on our resources.

Mr. **ABERNATHY**. We are talking about a Soviet benefit from oil.

Mr. **JENKINS**. Wayne, I don't think we are talking about helping the Soviets to develop oil. In fact, I think most oil experts, and I am not one of them obviously, feel that the Soviet's capability to produce additional oil is tailing off.

Mr. **ABERNATHY**. Oil and gas.

Mr. **JENKINS**. Gas is a different matter.

Mr. **VANOUS**. According to your reasoning, then by all means let's get together with the Arabs and push the price high. There is something pretty strange in your assumption about the domestic elasticity of supply with respect to price. Yours is the first argument that I heard that in fact we want to push prices up in order to be better off.

Mr. **Abernathy**. All you have to do is talk to some of the people who are trying to get a natural gas pipeline from Alaska, that are concerned about the price of gas decreasing to the point that the Alaskan gas would not be sellable when it finally got to the United States. That is just the price of gas and then there would be the questions of financing.

Mr. **Jenkins**. We don't have a real price of gas in this country yet, and if Senators Danforth and Eagleton have their way we won't have it for 2 more years. [Laughter.]

Mr. **Vanous**. Why buy Alaskan gas? Why not the Russian? If the Russians are willing to sell it for the right price, I would buy it from the Russians. It is their business at what cost they can produce; so long as they give us a competitive price why not buy the cheapest gas possible?

Mr. **Brown**. My question is directed principally to Dr. Hewett and Mr. Jenkins. In your remarks earlier you seemed to allude to the fact that the gains to be derived from sanctions were solely policy changes. How would you respond to the criticism that that is very narrow, and that there may be sort of economic deterrence, for example, involved in the invasion of Afghanistan with which we are trying to establish credibility. Furthermore, perhaps the domestic political arguments are not to be cast off so easily; that there are substantive benefits to be derived from an American populace supporting its President?

Mr. **Jenkins**. I think that is true and I think, if anything, I would argue for a strong Presidential response to every crisis of this nature. I do have great confidence in the public capacity to understand these issues, as I think I pointed out. But I think, on the other hand, the credibility of the President both with the American public and more importantly perhaps in the short run with the Soviet leadership of responding to a strategic military change by the Soviet Union with a marginal economic instrument on our part is counterproductive. It is negative. It does not enhance the prestige and the leadership image of the United States in the minds of Europeans or in the minds of the American public in my judgment, and it sure as hell doesn't shake up the Soviets which is what the objective should have been in the first instance in that situation.

I don't think that the sanctions which were to my mind so expensive in terms of the fabric of our Alliance, a point that Ed made, can in any way be considered proportionate.

Mr. **Brown**. Well, let's not talk about the pipeline. Let's talk about the grain embargo.

Mr. **Jenkins**. Again, I am not and maybe you aren't either in grain traffic, but the people who I talked to who are experts in international grain sales emphasized over and over again the fungibility of the grain market, that all we really did was transfer the business elswhere at a tremendous price to the American agricultural sector, and they cite the case which is the most extreme, but clearly true, of a dramatic jump in U.S. grain sales to West Germany who in turn had a dramatic jump in the sale of mill flour to the Soviet Union. They were sticking to the commitment not to sell grain to the Soviets, but their sales of flour skyrocketed.

We sold some grain to the Germans and thereby sold it to the Soviet Union. The fact is the impact on the Soviet Union was it was disruptive at the Port of Odessa, upsetting in their distribution mechanism which, God knows, is antiquated and difficult, some problems in feeding animals, no impact on bread supplies that anybody in our Western embassies could notice, and the impact on the Soviet population was virtually zero.

The expense to us, which I outlined to you, and again I am repeating what people who are experts in this have said, was very significant, maybe not macroeconomic, but I would hate to have you say that to Rudy Boschwitz. He thought it was very macro.

Mr. KOHN. Can you comment on the argument that it may have an effect on Soviet considerations in invading Afghanistan?

Mr. JENKINS. I think the Soviets moved into Afghanistan on the grounds of national security concerns which are so far out of proportion to any economic impact that we could have that it is not worthy of discussing it. If we want to impact their national security activities we have to have something of much greater impact than a grain embargo or any of the other piddling things that we do, and I am in favor of reacting. I am not pushing for no reaction.

Moderator HARDT. Let me interject a note that Dr. Wolf is going to make tomorrow morning and has made in his paper, and that is we often are looking at costs and then assuming what the Soviet leadership's reaction to our perspective of those costs might be. This is something that we are really not very expert in.

When you raise the question of deterrence everyone here has opinions, but we should be very cautious about those opinions and how they play their way out and are judged by historical patterns and other behavior. That element of measurement is an art.

Mr. JENKINS. I had a Soviet say to me when things were boiling up in Poland and it looked like they were going in and I was telling him if you go into Poland I am telling you the reaction in comparison to Afghanistan will be fearful. He said I know that, but it would be just as though Mexico were being taken over by Castro. You have to recognize the proportion of the importance to us in the national security terms of our principal and major ally. I don't consider Poland an ally of the Soviet Union.

Mr. KOHN. With grain being fungible in the long run, I don't see how the United States farm sector is going to suffer that much. What you are going to end up with is a rearrangement of your buyers and sellers.

I also think the point was made this morning that the Soviets apparently are interested in some diversification of their grain supplies.

Moderator HARDT. One of the variables is the increased planting that you can't avoid in Argentina, Brazil, et cetera.

Mr. JENKINS. It is the suddenness, Marty.

Mr. KOHN. Your points about the short run, the disruptive short run, I think there was a politically symbolic gain to be had from the grain embargo in late 1979 or early 1980. Maybe the price was not that high, given the fact that in the long run our farm sector apparently will not suffer. I think you were dealing with political symbolism at that time and perhaps it was necessary.

Mr. **Vanous**. Marty, you are assuming there is no supply response anywhere. The problem is a little bit more complicated. Your assumption is that there is a perfect grain market. So anything that is not exported directly from the United States is really reexported from elsewhere. For example, we sell grain to West Germany and they resell it to the Soviets. But actually you can get the supplier's response of the type you got in the case of Argentina and a little bit in Spain and France. There is a significant supply response and we can lose a portion of our share in global grain trade in the long run.

Mr. **Jenkins**. We have lost it in the Soviet marketplace and worldwide.

Mr. **Kohn**. What are the statistics on this? Let's get some figures out here that will give us total share. I would be interested to know. Changes in the U.S. share of world grain exports is what we should be looking at. I don't know the figures. I would like to know them. We have talked about huge disruptions and I would like to see the statistics supporting that.

Mr. **Epstein**. I would like to ask a somewhat broader question distinguishing between short-term denial policies and a long-term denial policy. How would you assess the costs to the Soviets if the United States were to undertake a long-term policy of denying them the benefits of trade with us? Now since they might just trade with our allies instead, the more important question is should we desire our allies to join with us in common in a policy of denying the Soviet Union these benefits? Now, obviously, that is not immediately possible, although once it was an existing policy.

Mr. **Hewett**. When was it an existing policy?

Mr. **Epstein**. Say the 1950's.

Mr. **Jenkins**. But it didn't work.

Mr. **Hewett**. Even in the fifties we had tremendous disagreements with Europe over this.

Mr. **Epstein**. Let's just say East-West trade was substantially smaller. The question is whether it in total over the long term has benefits to the Soviet Union which would be worth denying to them.

If political circumstances made this possible, would it be to our advantage to have such a long-term policy?

Mr. **Scuka**. This is a case of having opened a door and now trying to close it as opposed to having a closed door and keeping it closed. Now that the trade has been going on for a decade, it is very difficult to go back to step one.

Mr. **Epstein**. I certainly admit that this is a somewhat hypothetical question.

Mr. **Jenkins**. The British have been in favor of depoliticized trade since 1923 when they established their relations with the Soviets on the basis of a trading relationship. I think they have embodied this concept of totally depoliticized trade as a national policy, a cultural policy practically.

Mr. **Scuka**. They were pointing out a range of various governments' approaches to what they believed to be the basic foreign policy consideration concerning commercial transactions, and that variety simply does not yield now to any easy consensus. It does not seem to even lean toward the possibility of a consensus in terms of what the current administration is proposing or saying that they are discussing searching for an agreement this year or next. Whatever such international efforts may achieve, whether they reach an OECD or a NATO-wide agreement, the result is likely to be a papered-over compromise where England, France, and Germany especially are going to retain some of their own national considerations with a camouflage sufficient to pass for an acceptable international agreement.

Mr. **Jenkins**. Right. Total agreement and total consensus is clearly something we dream about, but the fact is that COCOM has existed and it has worked up to a certain point in certain areas and it has been recently expanded somewhat intelligently and I think there is ample room to assume that we can broaden that consensus somewhat.

Mr. **Scuka**. Would you agree that COCOM has had its ups and downs, too?

Mr. **Jenkins**. You know, the worst violator of COCOM standards historically has been the United States. We have asked for more exceptions, have pushed through more exceptions, have been tardy in responding and have sent the lowest level representation to participate in it of any of the allies.

I think we have it within our own hands to give COCOM quite a boost and I hope we do. I think this is a place where Lionel Olmer, and I am sorry he didn't come today, has done a very good job.

Moderator **Hardt**. I think we are reaching the point of winding up for this session. This discussion leads very well into tomorrow's discussion which gets to the broader aspect of European unified policy.

Ed, would you like to close with some comments?

Mr. **Hewett**. I wanted to respond to this gentleman's question. There is an issue which many people take seriously. Suppose somehow we could manufacture an agreement with Western Europe for a total embargo on trade with the Soviet Union. Would it be a sensible policy for us to pursue? I don't think so. If you just suddenly freeze trade between the Soviet Union and all other CMEA countries it would certainly have an impact on the Soviet economy and have an impact on Europe. You would close down steel mills in Germany and in France and so on.

But in the long run you would find you were engaging in an economic warfare with a country that has a potential to be self-sufficient at a not much lower GNP than it is at right now. And this is a country, which according to the President, is militarily the greatest country in the world.

That doesn't sound like a sensible policy. The opposite policy would seem to be a little more sensible; namely, to try to construct with the Soviet Union a web of interactions and of interdependencies that would bring us into contact in many ways and allow us to resolve reasonably the differences we have without having us light off firecrackers every time they do something in the world that displeases us, and it is that policy that I think many of us are pushing for.

I think what is behind some of the efforts in Washington to continue to push for economic warfare against the Soviet Union is this feeling that if we could somehow just get Europe to see the light that it would be a good thing. On the contrary such a policy could be a disaster.

Moderator HARDT. I think we will close on that note and reconvene tomorrow morning.

Thank you for coming.

[Whereupon, at 4:25 p.m., the workshop recessed, to reconvene at 9 a.m., Wednesday, December 15, 1982, in Whittall Pavilion, Jefferson Building, the Library of Congress.]

THE PREMISES OF EAST-WEST COMMERCIAL RELATIONS

WEDNESDAY, DECEMBER 15, 1982

United States Senate,
Committee of Foreign Relations
and the Congressional Research Service,
Washington, D.C.

The workshop commenced at 9:10 a.m., in Whittall Pavilion, the Library of Congress, John P. Hardt presiding.

Present: Charles Wolf, Jr., dean, Graduate Institute, Rand Corp., and program director, the International Economic Policy Program of the Rand Corp.; Angela E. Stent, professor of political science, Georgetown University; John P. Hardt, associate director for senior specialists, Congressional Research Service; William M. Reichert for Robert Roosa, partner, Brown Brothers, Harriman & Co.; and Stanley R. Sloan, senior analyst, Congressional Research Service.

Moderator Hardt. Welcome to the third panel on the workshop on Premises of East-West Commercial Relations.

In the first several panels there were many references and discussions to the actions of the President on November 13, actions involving the announcement of basic agreements among the allied countries on the policy toward trade with the Soviet Union, which were basis of lifting the sanctions on energy equipment.

This statement referred to an economic relationship which appeared to be emphasizing the economic strength of the Soviet Union as a factor in the overall strategic balance, which would suggest that improvement in their economic performance would be negative to our interests and therefore would be adverse to our policy views. Or our policy on economic relations with the U.S.S.R. could be interpreted differently based on statements of Secretary Shultz in Moscow and elsewhere that there was a range for normalized trade in the East-West as well as the United States-Soviet relationship.

Apparently on an assumption of a policy of normalized trade, the statement of the President called for a new set of rules for this economic relationship deriving from long-term studies. He specifically referenced: the area of energy focusing on the avoidance of undue dependence on the Soviet Union on the part of the Western industrial economies; strategic controls focusing on our concern about security factors in our relationship of trade to our broader interests; credit focusing on the avoidance of preferential credit to the Soviet Union and the other countries of the CMEA.

Also implied in the President's statement, and much discussed in the panels to date, was the foreign policy criteria of the Export Administration Act, which provided the basis for the recent sanctions and had been the basis of earlier sanctions and embargoes. These earlier sanctions and embargoes caused much discussion and difference of view among the Western allies, between the business community and executive agencies—as indicated by discussions especially from the National Association of Manufacturers in our first session—and between the Congress and the Executive—particularly as indicated by the hearings chaired by Senator Percy in July and August.

The President further announced agreement among the allies on a need for further studies. In these studies we may learn, how we are to proceed in terms of developing a unified policy of economic relations with the Soviet Union and with the East as a whole?

The panel will discuss the various aspects of this issue: the issues raised by the President in terms of developing new rules of conduct, the implications of unified or lack of unified policy, and the potentials for developing and the utility of developing a unified policy.

Dr. Wolf is the dean of the graduate faculty of the Rand Corp. He has been the chief of the Economics Division at Rand Corp. He has his doctorate from Harvard University. And he will be our first speaker.

STATEMENT OF DR. CHARLES WOLF, JR., DEAN, RAND CORP. GRADUATE SCHOOL, SANTA MONICA, CALIF.

Dr. WOLF. Thank you, John.

Good morning, ladies and gentlemen.

As I mentioned to John Hardt before we started, I did not have time to prepare a short enough statement to read. So what I would like to do is file my formal statement for the record and summarize its principal points, particularly emphasizing the ones that are additional to the points I made in the hearings that John alluded to in August held by the Senate Foreign Relations Committee.

There are four parts to this statement. I will be briefest in dealing with the first two parts and will elaborate the third and fourth parts.

In the first part of the statement I refer to the profound divergences, by and large, between European and American perceptions of the 1970's period of détente and the role of East-West commercial relations in contributing to détente.

And without going into the details that are recounted in my statement—and I am sure many of them were dealt with in the panels yesterday as well—I think it is fair to say that by and large, and acknowledging that the Europeans do not speak with one voice and are not of one mind on this set of issues any more than we are—the Europeans have concluded that détente and East-West commercial relations were generally a worthwhile course of action in the 1970's and they remain of value and applicability in the 1980's.

I think by and large, while acknowledging differences among us—and I am sure those differences are amply reflected by those on the panel—I think the consensus in the United States is that the period of détente and East-West economic relations have been weighed in the balance and found seriously wanting, and that there are serious grounds for scrutinizing and altering the premises of détente and East-West economic relations in the 1980's.

The second part of the statement begins by alluding to three broadly different policy orientations with respect to future directions of East-West economic relations that I dealt with in the August testimony:

One orientation is in the direction of embargoes and sanctions and at least selective economic warfare; a second broad policy direction involves concessions, subsidies and preferential encouragement of East-West trade, technology, and financial transactions: and a third policy orientation involves a strict market regime in which considerations of comparative cost and comparative advantage would mainly govern the quantities and composition of East-West trade without the distorting effects of either subsidies or sanctions.

The way I have posed those three probably suggests where my own preferences lie; namely, in the direction of the third of these orientations. I have purposefully overdrawn the distinctions among them. Of course, it is possible to have various combinations.

The reasons for my strong preference for the third broad policy orientation are: First, I think it reduces the political costs and difficulties with respect to alliance cohesion and with respect to domestic political pressures that would be involved in the first policy orientation of embargoes and sanctions.

It has the further advantage of limiting the benefits and eliminating the benefactions to the Soviet economy and those of its allies that would result from the second policy orientation of concessions and subsidies. And it would, finally, maximize the genuine economic gains from trade in accordance with more or less classical trade theory, if both concessions on the one hand, and sanctions on the other, were avoided.

Now, with that background. I discuss various rules of the game for implementing this third policy orientation of a market regime to govern East-West economic relations. These rules of the game are illustrated by three principal examples:

One involves the reduction and, hopefully, removal of Government subsidies in the form of Government underwriting of loan guarantees and export credit insurance. I might mention in passing it is possible to quantify the magnitude of the real subsidies involved in Government premia that are charged for loan guarantees and export credit insurance. In some work that we have under way and have partly completed at Rand, we have developed a method for estimating what the real cost of subsidies are. So this is not an abstraction; it is something that can be quantified and can be progressively removed.

The second rule that I propose is to eliminate concessionary interest terms on loans to the Soviet Union and other Eastern European borrowers, so that the interest charged on such loans should be equal to the highest interest on domestic or other foreign loans of equivalent duration.

Finally, the third rule would involve the removal of preferential tax treatment on income received by individuals and corporations in transactions with the CMEA countries. This would involve some modifications of the Domestic International Sales Corporation [DISC] program in the case of the United States, and removing several other tax preferences that are applied in Western Europe.

Now, what is the purpose of moving in this direction? Fundamentally, and simply, it is to avoid subventions to the economies of Eastern Europe and the Soviet Union, and thereby to reduce or eliminate net resource transfers from West to East. These net transfers amounted to more than $80 billion in the past decade, as reflected by the net debt accumulated by the CMEA countries, a quarter of which was owed by the Soviet Union. By reductions in net resource availabilities, Soviet allocation decisions would be constrained, and the possibilities would shrink for the Soviet Union to reconcile the competing resource claims of its military buildup, its requirements for internal investment and consumption, and the increasing costs of its expanded international empire in Eastern Europe and abroad.

I have no illusions, and one should have no illusions, about the magnitude or the immediacy of these effects. They will be modest, although I think not negligible, in the medium and longer term.

The third part of the paper deals with the rebuttal of two arguments that one finds frequently raised against moving in the direction of a market regime, let alone in the direction of sanctions.

One of these is that the policies I have advocated would constitutes economic warfare and, therefore, should be eschewed. And the other is that for this policy orientation to be effective, it would have to be implemented on a multilateral collective basis, that this is infeasible and implementation on a unilateral base will be ineffectual.

Briefly let me try to summarize the rebuttal of these two points that I deal with in somewhat more detail in the paper.

First, economic warfare is a subject whose terminology is immersed in ambiguity.

I might read a few of the definitions of what constitute economic warfare. For example, the Joint Chiefs of Staff, in the "Official Dictionary of Military and Associated Terms" of 1979, defined economic warfare as the aggressive use of economic means to achieve national objectives.

Another definition in the "Economics Dictionary" of Elsevier construes economic warfare as nonviolent activities aimed at making one nation's economy dominant over that of another nation.

I think probably the best and most comprehensive terminology is set forth in a good piece by Robert Loring Allen in the "Encyclopedia of the Social Sciences." He defines economic warfare as state interference in international economic relations for the purpose of improving the relative economic, military, or political position of a country.

And then he goes on to define interference as having two components: coercion, through denial of trade or resources or the threat to do so; and persuasion, through the conferral of economic favors by which a country may expect in return reciprocal favors in the form of political support or alliance or perhaps neutrality.

I have three comments to make about economic warfare which are summarized in my written statement. The first one is, frankly, a debating point. It is to suggest that the policy orientation I have proposed should be termed "economic realism" and distinguished from economic warfare to avoid the emotional connotations of the latter term.

The second comment is based upon the two components of economic warfare that the encyclopedia piece I referred to mentioned. As you recall from the quotation I read, one of these components relates to persuasion as an element in economic warfare, by which it is meant the conferral of economical favors with the expectation of extracting responsive reciprocal favors in some other form from the party or parties on whom the favors are conferred.

Now, if subsidies, which clearly are economic favors, represent economic warfare, then the withdrawal of subsidies can hardly be construed as economic warfare.

The third point is based upon another element in this piece in the encyclopedia. One clear and unequivocal example of economic warfare is cited as the conduct of state trading: "state trading is necessarily and automatically an example of economic warfare because the concentration of all external transactions in the hands of the government implies that trade is no longer solely a means of increasing the income of a country, but instead economic decisions are automatically transmuted into economic, political, and military decisions in which costs are balanced against benefits in all aspects of national life."

So that the rules of the game I am proposing, let alone more serious examples of government intervention that might be embarked on by the West, could be justified as a partial offset to the regular and systematic use of economic warfare by the Soviet Union.

The second argument that I want to rebut is that multilateral action is infeasible and, as I mentioned earlier, unilateral U.S. action would be ineffectual.

I acknowledge at the outset that collective action is far preferable to unilateral action both in terms of its prospective effectiveness in applying resource constraints to Soviet allocation decisions, and in terms of preserving and perhaps enhancing alliance cohesion.

But unilateral action is still likely to have a consequential effect. Provided it is handled tactfully and through efforts at understanding and effective intercourse with our allies, these actions are worth embarking on even in the absence of similar action by our allies. And for several reasons:

First, the international financial power of the United States is enormous. European bankers are likely to be much less confident and less willing to go it alone in the typical international financial consortia without U.S. participation than with U.S. participation.

Second, if the United States does move in the direction I have suggested, there would be a redirection of U.S. credit away from Eastern Europe and toward domestic uses and other international uses. Without going into details here I think this redirection would have beneficial consequences for the domestic U.S. economy and the non-Communist international economy.

Third, it is true that European exporters would realize some gains if their banks and governments did not observe the rules of the game that I proposed earlier. If, instead, the standard pattern of subsidies were continued, European exporters would realize some short-term gains—redistributive gains—from their economies as a whole to particularly the exporting sectors.

But these are likely to be short-lived gains because, over time, I think the accumulation of questionable loans to the CMEA countries in the asset portfolios of the participating European banks, would diminish the attractiveness of these banks to depositors and investment.

Now, a counterargument is that the Soviet Union itself is perhaps a good credit risk. Hence, there would not be a deterioration in the quality of the asset portfolios of Western European banks if they continue to make loans to the Soviets. The contention is advanced that the Soviet Union is a good credit risk because, after all, the quantity of its international debt is quite low. Its gross debt is about $17 billion or $18 billion, and its net debt is maybe a little more than half that. Its debt service ratio is relatively low, though higher than it has been in the past. The ratio of its net debt to its reserves is also relatively low, as is the ratio of its reserves to its monthly or annual import charges.

These are the ratios bankers look at. And so, therefore, the Soviet Union may appear to be a relatively good credit risk. And so Soviet debt assets would not be of questionable quality, and I think there are grounds for doubting this contention. Instead, I think the position of the Soviet Union as a borrower is really quite precarious, much more so than the admittedly favorable status of these four "bankers' " ratios might seem to imply.

Under plausible, but certainly not worst-case, contingencies, the position of the Soviet Union as an international borrower looks a lot more precarious and questionable than the conventional wisdom implies. These contingencies concern future Soviet oil production and international prices for fossil fuels, the future agricultural performance of the Soviet economy and its import of grains and prevailing international grain prices, the international gold market, and the international weapons market. These are the four principal sources of or demands for Soviet hard currency earnings.

I would remind you that the judgments of bankers in the past decade provide ample grounds for skepticism about the wisdom of their judgment concerning the Soviet Union's creditworthiness in the 1980's.

I conclude this section of the paper with a somewhat whimsical observation that even if the rules of the game that I have proposed are not applied multilaterally, and even if they were applied by the United States less rigorously than I would like to see, the invisible hand of the market may accomplish what the visible hands of government do not. The reason is that international capital markets in the 1980's are likely to be much more severely supply constrained than they were in the 1970's, so that access by the Soviet Union and Eastern Europe to capital is likely to be much more limited anyhow.

Finally, let me address the point about Soviet behavior and the effects of the measures I have proposed on Soviet behavior.

First, it is worth making explicit the components of Soviet behavior that I think it would be in our unilateral and collective alliance interest to try to affect. These components include: Soviet military efforts and its military buildup and military investment, both conventional and nuclear, especially conventional; the direct and indirect use of Soviet military power in various parts of the world, such as Afghanistan; the persistent efforts to expand the Soviet empire and Soviet influence abroad; and the repressiveness of the Soviet system both at home and in Eastern Europe.

I think these are the components of Soviet economic behavior that we would like to be able to affect in some way. And the question is: What effect, if any, would the sorts of measures that I have proposed have on any of those components of Soviet behavior, and over what time horizon?

There are three hypotheses that can be formulated concerning the likely Soviet response in the several dimensions.

The first hypothesis is that the kind of policy measures I have proposed would be so provocative that the Soviets might actually devote even more effort to these forms of behavior, to military spending and external mischief and internal repression, notwithstanding the diminution of their aggregate resource base. In other words, it would be provocative and would motivate and mobilize just the wrong sorts of responses.

The second hypothesis is the opposite of this; namely, that the kind of measures I have proposed would instead lead the Soviets to adopt a more accommodating and conciliatory stance once they became convinced of the firmness and credibility of United States and Western intentions.

The third hypothesis is the so-called null hypothesis; namely, that Soviet behavior may not be discernibly affected by the policy measures I have proposed. In general, where the evidence in support of either of the other hypotheses is inconclusive, one should not reject the null hypothesis that says, in effect, Soviet behavior will not change appreciably from what it otherwise would be. Instead, Soviet behavior may be impelled by internal pressures, forces, and factions and the relative strength of these is unlikely to be influenced by Western economic policy.

I have heard, as I am sure you have, plausible hypotheses in support of each of the first two mutually inconsistent hypotheses. I suspect there are members of the Senate committee and the audience here who are inclined to favor each of them.

My own inclination runs strongly toward supporting the null hypothesis until there is much stronger evidence than anyone has thus far produced in favor of either of the other two.

Soviet priorities and behavior are likely to be governed by factors inherent in the Soviet system rather than by changes in Western economic policy. And these factors are not very different for Andropov than they were for Brezhnev. This seems to me to argue strongly in favor of the policy orientation I have been proposing. Why do I reach this conclusion?

At the least, a policy of restricting resource flows, by removing the subsidies that have lubricated such flows in the past, would place greater pressure on the Soviet economy in the middle and longer run. Such a policy would thereby tend to expose the inherent economic, political, and social contradictions, the dialectical contradictions, if you will, within the Communist system.

And it seems to me this is simply a policy of economic realism. It is not a policy for bringing the Soviet Union to its knees. It is not a policy for bringing about the collapse of the Soviet system, as some of the media's caricatures of the policy have occasionally portrayed it. Indeed, the effects on Soviet behavior of such a policy of resource restriction would be modest and gradual and would be felt only over the longer run.

This argues for moving our policy on East-West economic relations in the direction I have proposed now rather than later.

We should certainly not try to outdo Lenin's forecast by subsidizing the rope with which to hang ourselves.

Thank you.

[Dr. Wolf's prepared statement follows:]

PREPARED STATEMENT OF CHARLES WOLF, JR.[1]

Mr. Chairman, members of the Committee and of the Congressional Research Service of the Library of Congress, I want to express my appreciation for this opportunity to discuss further with you some of the matters on which I testified before the Committee in August 1982.

At the outset, I would like simply to note that sensitive and controversial policy issues, such as the one we are addressing in this workshop, often elicit from putative experts a mixture of genuine expertise—that is, facts, analysis, and knowledge—combined with opinions, personal preferences, and political sympathies. Moreover, the proportions of these ingredients are sometimes not evident to the audience, and occasionally not even to the experts themselves. Part of the reason, I think, is that the "bottom line" on the issue of East-West economic relations relates to beliefs about Soviet behavioral responses that really have quite fragile analytical underpinnings. None of us is truly expert on Soviet behavioral responses, and I think it is fair to say that genuine expertise on the Soviet economy, or on international trade and finance, provides very little basis for prescience in judging prospective Soviet behavior. Instead, in judging Soviet behavioral responses, what we tend to fall back on are our own tacit premises about the nature of the Soviet system and the Soviet decision-making process, and the connection between decision-making with respect to Soviet domestic policies on the one hand, and Soviet foreign and defense policies, on the other.

My own views on these fundamental, but elusive matters will, I hope, become clearer as I proceed, and clearer still in the discussion which follows.

The following remarks will cover four separate points: First, European perceptions of the period of détente, and of its relationship to East-West commercial transactions.

Second, a set of specific "rules of the game" for conducting East-West economic relations in a manner that reduces or removes the pervasive subsidies that have supported those transactions in the past.

Third, I will consider and rebut two arguments that are often made against imposing rules and restrictions of the sort I have proposed: (1) the argument that this would constitute "economic warfare," and hence should be eschewed; and (2) that unilateral observance of these restrictions by the United States would be ineffectual, and multilateral observance by our allies is implausible.

And, finally, I will conclude with a few comments about the probably limited, but not negligible, effectiveness of the sorts of restrictions I have in mind.

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[1] Charles Wolf, Jr. is dean of The Rand Corporation's Graduate School, and director of Rand's research program on international economic policy. Comments in this statement are the author's views, and not necessarily those of The Rand Corporation or any of its research sponsors.

I. EUROPEAN AND AMERICAN PERCEPTIONS

It is a mistake to think that our European allies are of one mind, or that they speak with one voice on these matters, any more than Americans do. Nevertheless, there are, by and large, sharp differences between the median or average views of our European allies, and most of us in the United States, in our respective evaluation of the results of détente, and of the role of expanded East-West economic relations in contributing to détente. Our European allies look at the world through lenses that focus on quite different experiences from those that occupy the center of our field of vision. For example, the Europeans see and commend the emergence of Solidarity in Poland prior to December 13, 1981, the development of decentralized, market decision-making in the Hungarian economy, and the seeming independence of Rumania's foreign policy. Our allies, especially the Federal Republic of Germany, also see the humanitarian as well as the political benefit of reuniting 200,000 German families previously separated by the barriers between the FRG and East Germany.

Moreover, our European allies see this as having come about while they have conducted only a relatively modest volume of trade with Eastern Europe and the Soviet Union, amounting to less than 5 percent of Western Europe's total external trade. They also see the clear signs of weakness and the declining prospects of the Soviet economy, reflected in its low and decreasing rate of growth, declining productivity, increasing capital-output ratios, repressed inflation, and labor shortages. Finally, from this evidence our European friends infer, perhaps wishfully, that the Soviet Union is likely to be preoccupied with its own problems, and may not really be such a serious threat and adversary, after all.

By contrast, I think most of us in the United States see a different set of consequences of détente. We see instead a tremendous buildup of Soviet military power, both nuclear and conventional, and naval, air and ground forces; a rate of growth in Soviet defense spending throughout the past decade somewhat greater than the rate of growth in Soviet GNP; and a level of Soviet military investment many times larger than our own.

We also see the Soviet invasion of Afghanistan in 1979, the imposition of martial law and the repression of Solidarity in Poland *after* December 13, 1981, the continued expansion of the Soviet empire in Angola, Ethiopia, South Yemen, Laos, Cambodia, and Nicaragua, and the adroit deployment of proxy forces with very substantial Soviet military and other support to accomplish this expansion. We also note the tremendous growth of debt owed to the West by Eastern Europe and the Soviet Union, amounting to over $80 billion, of which three-quarters is owed by the Eastern European countries. And we worry that this debt makes our European allies hostage to Soviet influence and pressure. Moreover, we see the limited, as well as short-lived, reactions of our European friends to the Soviet invasion of Afghanistan, and to repression in Poland, as confirmation of precisely the sort of hostage behavior we have been concerned about.

In sum, the countries of Western Europe—by and large, and with some differences among and within them—look favorably upon détente and its fundamental, underlying premise concerning the salutary effects to be expected from expanded economic relationships. They conclude that this premise was valid and useful in the 1970's, and remains applicable in the 1980's.

By contrast, we in the United States—by and large, and also with some differences among us—have concluded that détente and its premise "has been weighed in the balance and found seriously wanting." We have concluded that we should envisage major changes in our relations with the Soviet Union in general, and in our economic relations in particular. We have concluded that the policy of seeking to influence and moderate Soviet behavior by encouraging expanded economic relationship has failed badly—so badly that its underlying premise should be discarded.

II. RULES OF THE GAME

Mr. Chairman, in my statement to the Foreign Relations Committee on August 12, I distinguished three different policy orientations toward East-West economic relations: (1) embargoes or sanctions, representing a policy of selective economic warfare; (2) subsidization to encourage East-West transactions beyond what strict market considerations would warrant; and (3) reducing or removing the pervasive network of subsidies on such transactions that have developed over time, while letting the market function to facilitate or restrict commercial transactions in accord with the differing economic conditions and prospects prevailing in the Eastern European and Soviet economies.

As I indicated at that time, I strongly favor the third policy. What I would like to propose at this time are some specific measures for implementation, for "putting teeth" into such a general policy orientation.

The following are several specific examples of what I would suggest as "rules of the game" for East-West economic transactions:

1. No loan guarantees or export insurance should be available to Western lenders or investors engaged in transactions with the East unless these guarantees are extended without direct or indirect government underwriting (of the types provided by government and quasi-government agencies in West Germany, France, the United Kingdom and the United States, in the past).
2. No concessionary interest terms should be available to either government or commerical borrowers in Eastern Europe or the Soviet Union. The minimum criterion for implementation of this rule should be that interest rates applying to loans to Eastern Europe and the Soviet Union should not be less than the highest rates charged to domestic or other foreign borrowers on loans of equivalent duration.
3. No preferential tax treatment should be accorded to either individual or corporate income derived from transactions with Eastern Europe or the Soviet Union. (For example, the preferential tax treatment extended under the Domestic International Sales Corporation Program in the United States would have to be modified to comply with this rule).

What is the purpose of these proposed rules? It is fundamentally to reduce and remove the subsidies that have undergirded economic transactions with the Soviet Union and the other CMEA countries over the past decade, and have thereby contributed to the huge expansion of net resource flows from West to East. The intended result is to restrict such resource flows in the future to no more than an unsubsidized market will allow. Such restrictions can help, albeit only modestly, to constrain Soviet allocation decisions, to impede the management and expansion of the Soviet empire and, hopefully rather than assuredly, to bring resource pressures to bear in the longer run that will help reduce the Soviet military buildup.

For reasons I will discuss in more detail later, one should have no illusions that a policy of this sort will have short-run or dramatic effects on Soviet behavior. But at least such a policy will shrink the possibilities open to the Soviet Union for reconciling continued expansion of its military capabilities, with the competing demands of consumption, investment, and economic growth at home, and of its expanded empire abroad.

III. ARGUMENTS AGAINST RESTRICTIONS

Two arguments are usually raised against such attempts to put teeth into the "rules of the game" of East-West commerce. One argument is that such measures would amount to "economic warfare," and would, therefore, be politically undesirable, especially from the viewpoint of our European allies. The second argument is that, while such "rules of the game" might have some effect if they were applied collectively by the West and Japan, this is unlikely to ensue and unilateral application will have negligible effects. I will comment briefly on each of these arguments.

The term "economic warfare" does not have a very precise technical meaning, and the loose and diverse ways in which it has been used in the media and elsewhere have not contributed to resolving these ambiguities.

The official "Dictionary of Military and Associated Terms of the Joint Chiefs of Staff" defines "economic warfare" as "aggressive use of economic means to achieve national objectives."

Another definition, in Elsevier's "Economics Dictionary," defines "economic warfare" as "non-violent activities aimed at making one nation's economy dominant over that of another nation."

Probably the best and most comprehensive definition is presented in "The Encyclopedia of the Social Sciences," which defines economic warfare as "state interference in international economic relations for the purpose of improving the relative economic, military, or political position of a country." "Interference" is further described as having two components: "coercion," through denial of trade or resources, or the threat to do so; and "persuasion," through conferral of economic "favors . . . [by which] a country may expect in return reciprocal favors in the form of political support, or alliance, or perhaps neutrality." [2]

I have three comments to make about "economic warfare."

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[2] "The Encyclopedia of the Social Sciences," p. 471.

First, I suggest that the "rules of the game" I am proposing should be termed "economic realism," and should be sharply distinguished from the more "aggressive use of economic measures" constituting "economic warfare."

Second, it is worth noting that, as I've previously noted, one of the two components of economic warfare as elaborated in "The Encyclopedia of the Social Sciences," consists in the use of "persuasion," through the conferral of economic "favors." According to this view, it would seem that the West itself has, ironically, already been engaging in economic warfare by the very fact of extending the "economic favors," that is to say, the subsidies in the past decade that I have referred to earlier. If provision of subsidies is itself a form of economic warfare, then their reduction or removal can hardly be said to constitute economic warfare! (Incidentally, it's worth noting, as the Encyclopedia article by Robert Loring Allen does note, and as our European allies usually overlook, that the very act of attempting to use persuasion may "render the initiator vulnerable . . . If the trade is large for the recipient, it is also large for the initiator, and the recipient under some circumstances may subject the initiator to pressure through the same relations that the initiator is employing.")

Finally, the discussion of economic warfare in the Encyclopedia, observes that any "nation which practices [state trading] is necessarily and automatically engaged in economic warfare . . . [because] the concentration of all external transactions in the hands of the government implies that trade no longer is solely a means of increasing the income of a country. Economic decisions are automatically transmuted into economic-political-military decisions in which costs are balanced against benefits in all aspects of national life." [3] In other words, it is the Soviet Union which, by virtue of its state trading, is inherently and regularly engaged in economic warfare! This suggests that some forms of state action on the part of the West to offset the economic warfare normally practiced by the Soviet Union is justifiable.

Mr. Chairman, I am sure you will recall Lenin's maxim that "When we are ready, the West will sell us the rope with which to hang them." I would submit that while refusing to sell the rope may be economic warfare, refusing to give it away, or to subsidize its sale, is certainly not; even placing a tax on its sale would not necessarily be economic warfare.

The other argument that I want to rebut concerns the effectiveness of applying the "rules of the game" unilaterally, if they are not acceptable multilaterally.

There is no question that multilateral action in concert with our Western European allies and Japan is far preferable to unilateral action by the United States alone, both in terms of the effectiveness of these proposed rules in achieving the objectives I've described earlier, and in terms of improving cohesion within the alliance. Nevertheless, I believe that announcing and observing these rules unilaterally would be worthwhile, even if our allies did not follow suit.

One reason is simply that the United States has tremendous influence in the international financial community. If U.S. banks and exporters were to follow these rules, several consequences would ensue:

1. Other members of the international financial community would simply feel less confident and more reluctant to "go-it-alone" without U.S. financial participation in financial consortium arrangements. While European exporters might realize some one-sided gains, these would probably be short-lived.
2. American banks would extend more credit domestically, and in other parts of the world outside of Eastern Europe and the Soviet Union, relative to what would be the case if the subsidies on transactions with the CMEA countries were continued; in other words, U.S. credit would be redirected with some beneficial consequences that we may wish to consider in the later discussion.
3. Even if the European banks were to go ahead with the credit extensions that are sustained by the continuation of subsidies by their governments, I conjecture that the asset portfolios of such lending institutions would, over time, be compromised by the accumulation of these questionable debt instruments acquired from the CMEA countries. Consequently, these institutions would become less attractive to depositors and investors than would their American counterparts. Anticipation of this outcome would very likely lead the European institutions to follow a more prudent course of action.

It is true that the Soviet Union itself is conventionally viewed as a good credit risk: its net outstanding debt is modest, unlike that of most of the countries of Eastern Europe; its debt service ratio is reasonably low, although higher than it has been in the past; its ratio of hard currency reserves to monthly import costs its relatively high. These are the ratios that bankers typically look at, so one might argue that credit extended to the Soviet Union would not appear to be a too-risky asset for European banks to acquire even without participation by U.S. lenders.

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[3] Ibid.

On the other hand, it's less well-recognized that the credit-worthiness of the Soviet Union is really quite precarious. Several adverse, but by no means "worst case," contingencies can sharply reverse Soviet credit prospects. Such contingencies would include, for example, reductions in Soviet oil exports and continued soft world fuel prices, continued poor Soviet agricultural performance together with large Soviet grain imports and high world grain prices, continued softness in the international gold market, a diminution in the international market for weapons (which has been an important hard currency earner for the Soviet Union in recent years), and other plausible circumstances.

I conclude this portion of my remarks with one slightly whimsical observation. Even if the "rules of the game" I've been advocating are not adopted multilaterally, and even if they're applied less rigorously by the United States than I would like, the "invisible hand" of international financial markets may accomplish a good measure of what the visible hands of government do not. In the 1980's, international capital markets are likely to be severely supply-limited, so that the Soviet Union and Eastern Europe will find their access to foreign capital sharply reduced compared to the 1970's, even apart from the governmental policies I've been proposing.

IV. EFFECTS ON SOVIET BEHAVIOR

How would Soviet behavior be affected by the sort of policy I have been proposing?

It may be worthwhile, first of all, to decompose "Soviet behavior" into the component parts we wish to affect: (a) Soviet military efforts and buildup, both conventional and nuclear; (b) direct and indirect use of Soviet military power in various parts of the world, such as Afghanistan; (c) persistent efforts to expand the Soviet empire and Soviet influence abroad; and (d) the repressiveness of the Soviet system, both at home and in Eastern Europe.

Three hypotheses can be formulated concerning the likely Soviet response. The first hypothesis is that such a policy may be so provocative that the Soviets might actually devote even more effort to military spending and external mischief, notwithstanding diminution of their aggregate resource base.

The second hypothesis is that they might, instead, adopt a more accommodating and conciliatory stance, if they became convinced of the firmness and the credibility of Western and U.S. intentions.

The third hypothesis is, to use slightly technical terminology, the "null" hypothesis: Soviet behavior and Soviet preferences may not be discernibly affected by this policy, at all. In general, where the evidence in support of either of the other hypotheses is inconclusive, one should not reject the (null) hypothesis that says, in effect, Soviet behavior will not change appreciably from what it would otherwise be.

Instead, Soviet behavior may be impelled by internal pressures, forces, and factions, and the relative strength of these is unlikely to be influenced by Western economic policy.

I have heard plausible arguments advanced in support of the first two, mutually inconsistent hypotheses. I expect there are members of the Committee, as well as others in this room, who are inclined to favor each of them. My own inclination runs strongly toward supporting the null hypothesis until there is much stronger evidence than anyone has thus far produced in favor of another hypothesis. Soviet priorities and Soviet behavior are likely to be governed by factors inherent in the Soviet system, rather than by changes in Western economic policy, and these factors aren't very different for Andropov from what they were for Brezhnev.

This conclusion seems to me to argue very strongly in favor of the policy direction that I have been proposing to you. At the least, a policy of restricting resource flows, by removing the subsidies that have lubricated such flows in the past, would place greater pressure on the Soviet economy in the middle and longer run. Such a policy would thereby tend to expose the inherent economic, political, and social contradictations within the Communist system. This is simply a policy of economic realism; it is not a policy for bringing the Soviet Union "to its knees," or bringing about the "collapse of the Soviet system," as some of the media's caricatures of the policy have occasionally portrayed it.

Indeed, the effects on Soviet behavior of such a policy of resource restriction will be modest and gradual, and will be felt only over the long run. This argues for moving our policy on East-West economic relations in this direction now, rather than later. We should certainly not try to outdo Lenin's forecast by subsidizing the rope with which to hang ourselves!

Moderator HARDT. Thank you very much. You will note that Dr. Wolf took some of the approaches of the statement of President Reagan of November 13; namely, the call for establishing rules, and carried them forward and helped, I think, sharpen our thinking on this subject.

As we look to the issue of a unified Western policy—and we are attentive to the fact that many of our policies are based upon an assumption that there is a Western policy and a unified Western policy—we should look at the European premises for this policy.

Prof. Angela Stent is very well prepared to deal with the multinational aspect of this question. She did her doctorate in the relationships between West Germany and the Soviet Union at Harvard University. She has authored the well-known book "From Embargo to Ostpolitik," which is now to appear in German. She has followed the issues of East-West trade in many facets, particularly from the standpoint of alliance policy.

STATEMENT OF DR. ANGELA E. STENT, GEORGETOWN UNIVERSITY, WASHINGTON, D.C.

Dr. STENT. Thank you, John. I am very pleased to be able to participate in this workshop discussing issues that stir the hearts and minds of all of us involved with them, yet frustrate us all because their answers are so elusive.

It is, indeed ironic that the greatest postwar crisis in the Soviet empire, namely, the disintegration of the Polish social fabric, has caused one of the most severe postwar crises in the Western alliance, precisely over how to respond to the Polish situation and whether economic sanctions are, indeed, an appropriate response.

I will briefly summarize my statement and perhaps throw out a few more thoughts. My task was to examine the European premises on East-West trade, and suggest in what areas compromise with the United States was possible. Let me just emphasize that I am explaining the European view. I do not necessarily support all of its components. I am explaining, not defending, the European position, and I hope we can discuss that.

I will divide my remarks into three parts. First, I will briefly outline the European approach to the politics and economics of East-West trade. Second, I will differentiate between the views of our three most important allies, the Federal Republic of Germany, France, and the United Kingdom. I am sorry, I will not discuss Italy in my remarks. I will be happy to talk about it afterward with you. I think our other allies are more minor players in these questions.

Third, I will sketch out areas of potential agreement on these issues. But my bottom line is what you already probably know and what we heard yesterday, and Dr. Wolf has just discussed—the Europeans espouse fundamentally different attitudes toward East-West commercial relations than we do. And as long as we are so far apart, any realistic compromise will be very, very hard to reach.

Basically, the Europeans, as Dr. Wolf said, view East-West commercial ties as a normal, desirable element of their relations with CMEA nations for both political and economic reasons. The main debate in the media over East-West trade in Western Europe today is not what should we sell to the Soviet Union or Eastern Europe, but how can we deal with the United States on these problems.

So East-West trade in the European mind is much more a West-West problem at the moment than it is an East-West problem.

One basic reason for this is that deténte in Europe has worked, as we have already heard. Our allies had more limited regional expectations of détente than we did, and the Soviet Union has consciously abided by its détente commitments in Europe. It has persuaded our allies quite cleverly that they do, indeed, have a continuing stake in détente.

The United States does not recognize that the stabilization that has occurred in Europe is a success for American détente policy, which in fact, it is. I think we should take more credit for the stabilization in Berlin and what has happened in Europe. We are largely responsible for it.

Rather, we tend to concentrate on Soviet violations of what we considered an agreed-upon détente code of conduct and which are indeed serious. In fact, one could argue that détente was hardly given a chance to work in the United States for a variety of domestic and foreign policy reasons that are probably familiar to all of you, not the least of which—and I think we tend to forget this—was the aftermath of the Vietnam war. Then congressional measures, such as the Clark amendment, were passed to prevent U.S. involvement in another potential Vietnam. These measures diminished the U.S. ability to respond to Soviet expansionism in the Third World; in this case, in Angola.

But this does not mean that détente itself was responsible for our inaction and our inability to respond to the Soviet Union. You can't blame détente for everything. Nevertheless, détente has been discredited in this country, whereas it is alive and well in Europe. And economic relations with CMEA, as were pointed out already, have been an integral part of this European relationship.

The Soviet Union has, of course, pursued a deliberate strategy of decoupling Europe and the United States and its policy toward the West, so the U.S.S.R. has played an active role in convincing the Europeans of their continued stake in détente.

Moreover, the Europeans do not share our definition of security. Essentially, the American concept of security is overwhelmingly military in nature, whereas, that espoused by the West Europeans is almost equally economic. From an American perspective, the additional economic security through increased employment that nonagricultural exports to the East may bring, is more than outweighed by the threat to national security implied in strengthening the Soviet economy through Western technology and manufactured exports.

The Europeans, however, believe East-West trade benefits both sides. Moreover, the Reagan administration has broadened its definitions of what constitutes a security threat to the West.

While all COCOM members agree on the need to control exports that have direct application to Soviet military power, the U.S. Government now claims that all goods and technologies that contribute indirectly to the conduct of war; namely, all exports that strengthen the entire Soviet industrial base and energy infrastructure, that these nonagricultural exports represent a security threat.

So one reason why the United States and its allies are in conflict over East-West trade is that the United States has a narrower definition of what contributes to national security, and a much broader definition of what threatens national security than does Western Europe.

Moreover, the United States has always taken the lead in defining the security aspects of East-West commerce; whereas, our European allies have mainly been preoccupied with its economic benefits. And this asymmetry has meant that the United States always takes the initiative in East-West security-related trade questions, while our allies always respond passively. It would be good if our allies took a little of the initiative sometimes, and we should encourage them.

There's also a basic economic reason for the European interest in East-West trade which bears repeating. European economies are far more trade-independent than is our own, and in times of high unemployment and recession in Western Europe, East-West trade appears as a stable guarantor of export markets. For this reason, the Europeans oppose the principle of economic sanctions because of the economic cost they impose.

But the Europeans also oppose sanctions because they dispute their political utility as a means of changing Soviet behavior on all crucial political issues. The Europeans accept the principle of positive linkage, of using trade incentives to modify Soviet behavior on minor political issues that are marginal for the Soviet Union, although not for us, such as emigration. But the Europeans oppose the principle of sanctions. They will only agree on a policy of positive linkage if they have to link politics and trade in East-West relations.

All European Community members more or less share this view of East-West trade. Of course, there are dissenters within Europe. There are people who agree with the Reagan administration's position. There are also people on the left who take a different view. But what I have outlined represents the consensus in Western Europe today.

However, there are differences among our key allies on aspects of these questions. The Federal Republic of Germany is in a unique category for largely political reasons. We may not want to paraphrase Freud—because this sounds rather deterministic—and say geography is destiny. Germany is, however, much more dependent upon Soviet good will for its essential security and political goals than is any other West European country.

West Germany is beholden to Soviet good behavior in its attempts to improve links with West Berlin and to intensify intra-German ties. The Soviets are well aware of this. They have largely delivered the goods to the Germans, and the Soviets have also made explicit emigration and humanitarian concessions in return for direct German financial aid and other quid pro quos.

The current Christian Democratic coalition government in Germany has the same attitude toward East-West trade as did its Social Democratic predecessor, as I established recently in talks with these officials in Germany. This is a product of the traditional nature of Soviet-German ties, of the historical and geographical determinants of this relationship.

Moreover, trade with CMEA is very important for certain sectors of the German economy, particularly, the ailing steel industry. Germany's overall dependence on East-West trade is very small—roughly 8 percent of its foreign trade is with CMEA nations, and 2.2 percent with the Soviet Union. That's not really very big, but East-West commercial ties are sectorally disproportionately important for certain industries.

Germany has the greatest economic and political stake of all of our allies in East-West trade, so that would suggest that they would be the least cooperative with American policies. But because Germany is particularly dependent on U.S. security protection, it has been, up until now, more willing to compromise with the United States on certain East-West trade and financial questions than are any of our other West European allies.

For instance, Germany was the only major European country that did not send its athletes to Moscow when we announced the Olympic boycott. It did this somewhat unwillingly, but at least Chancellor Schmidt complied with us.

France and Britain, by contrast, have a smaller economic stake in commerical relations with the Communist nations. They are also far more skeptical about détente. Neither the French or British today will defend détente as much as the Germans will. The French and the British are also much more skeptical about the political value of trade than is West Germany. They haven't really secured any political concessions in return for trade. They also haven't sought them in the same way the Germans have.

Both the French and British Governments today take a harder political line toward the Soviet Union than does Germany, but this harder political line does not extend to economic relations. We saw Mrs. Thatcher supporting the firm John Brown when it was exporting pipeline compressors to the Soviet Union in defiance of U.S. sanctions. And French President Mitterrand's stance is well-known to all of you.

The French have reluctantly agreed to support Secretary Shultz' initiative to study East-West trade issues as a compensation to the United States for President Reagan's lifting the pipeline sanctions. The British, who behave in a more overtly cooperative way, agreed to support the studies earlier on while the French delayed.

Both France and Britain have sought to depoliticize East-West trade from early times. Kempton Jenkins said yesterday that the British have depoliticized trade since 1923. The French have more or less tried to do that, too.

Moreover, both the French and the British officially subsidize credits to CMEA nations. I mention this because this is an integral part of their commercial policy with all nations, and this makes it much more difficult to discuss credit compromises with them. They believe in East-West trade for purely commercial reasons, not because they think that it brings political results. They want to maintain East-West commercial ties for economic reasons, and they do not like to decouple trade and credits in their discussions with the United States, because they feel that without subsidized credits their products would not be competitive on the Soviet and East European market. That is their view, rightly or wrongly, and it is what we have to contend with.

Now that I have briefly outlined the European position, let me turn to a few key areas where some improvement in United States-European coordination on East-West commercial ties might be possible.

Let me say that I am not very optimistic about the possibilities of any real improvement, although I certainly welcome Secretary Shultz' latest initiative in this area. I think this is a very positive sign on the European part as well.

But beyond an agreement in principle to discuss things, the Europeans are so acutely aware of their economic difficulties that the idea of restricting East-West trade is very unpopular domestically. It would be very hard for the German Government, for instance, to win the March election in a time of the worst economic crisis since the war on a platform of restricting East-West trade and cutting back jobs. It's politically impossible, and we must understand that.

It seems the COCOM area is the most hopeful one for a United States-European agreement. All European members of COCOM agree that the lists have to be revised, and they are to some extent cooperating in the current list reviews in Paris. Still, there is a reluctance to accept the American definition of critical technology as outlined in the DOD Bucy Report, and this concept is, of course, embodied in our Export Administration Act.

We do come back to the question raised yesterday on the panel: How do you arrive at an acceptable common definition of such an elusive concept as what constitutes high technology? If we don't arrive at a common definition, all of our attempts to improve the COCOM system will ultimately be frustrated. If we can't get the Europeans to accept our concept, and if we cannot translate the theoretical concept more effectively into practical export licensing decisions any agreement will evade us. How do you differentiate between technology and product? It is very hard when you try to implement the critical technology theory, but we must try.

Now to the credit area, the second area that we clearly do have to discuss with our European allies. I think the credit area is the one in which we should be pressuring the Europeans, although the signs are not very hopeful. The Germans are in a different category here. They don't officially subsidize rates of interest on credits to Communist nations. Of course, they do grant official insurance for credits through the Hermes Corp. As Dr. Wolf said, this is a form of subsidy, and that is something we should be discussing with the Germans, too. But they don't subsidize their credits as much as our other allies do.

The French, it seems to me, are the real stumbling block on the credit issue, more than the British. Since the early 1960's both France and Britain have refused to differentiate politically between Communist and non-Communist countries when they make credit-subsidization decisions. Neither the private banks, nor the government believe in discriminating against CMEA nations on credit terms.

Britain and France claim their credit and trade policies are inseparable. They stress that they need subsidized credits to compete with other Western countries on the world market. It's hard for me to see how the French would go beyond the OECD consensus interest rates, or limit the volume of credits but, of course, we must try and encourage them to do so.

We should also ask ourselves what good a credit agreement would be if the French refused to go along. Could we have a viable credit agreement with the rest of our Western European allies if the French don't support it? It is, of course, convenient for our allies if the French don't go along. They can hide behind the French and say that they would like to cooperate but would be at a commercial disadvantage if the French pursue a different policy. So we will have to work on the French if we want to get an agreement.

Let me finally come to U.S. foreign policy controls that were raised in the discussions yesterday. The foreign policy controls in our Export Administration Act are a major problem for the Europeans, as they are, of course, for our own American corporations, as we heard yesterday.

If we are to reach a new consensus with our allies—and I think it's worth trying it before we take the unilateral action—we must have a consistent and predictable policy. The use of foreign policy controls is inimical to any kind of consistency in East-West trade policy.

No European government questions the need for national security controls. But foreign policy controls that enable the President to turn trade on and off in response to short-term Soviet political behavoir, play havoc with our allies' ability to fulfill contracts. The pipeline sanctions are the most dramatic example of that, when we could not have prevented the project from coming to fruition but we could have delayed it by a couple of years.

The Europeans object to the principle of United States turning trade on and off like a light switch, as our Secretary of State himself has said, and this inhibits our ability to develop a credible, consistent policy on East-West trade.

But having said that, I return to the question, finally, that we raised yesterday: How are we to react to Soviet actions if we agree that we cannot use military means, and if we are not going to use short-term economic sanctions? I don't have any easy answer to that.

Perhaps some elements of East-West trade, like the terms for granting credits, could be used for foreign policy purposes. We could offer credits on better terms perhaps in return for some minor political concession from the Soviet Union or Eastern Europe. We might be able to use credits as a carrot, but even then we would have to coordinate such a policy very carefully with our allies.

The foundation of a new transatlantic East-West trade consensus must be a greater degree of predictability in long-term industrial and agricultural projects. We should reach an agreement with our allies, for instance to go ahead with certain projects; for example, a pipeline, a large steel mill or something like that, or sales of grain, or we should reject projects after due discussion. But once we agree to go ahead, we shouldn't try to interfere with projects 1 to 2 years later.

That means, of course, that when a new administration comes into office in this country, it should not feel that it has to show that its policy is different from the previous administration's; it should be more willing to accept the principle of continuity. If we want the Europeans to accept our suggestions, be willing to compromise on certain other areas of East-West commercial relations, we must have a more consistent policy.

I think it's asking a lot from our Government to expect it to come up with all these proposals. It would be nice if the Europeans would take the initiative, but they are reluctant. They would rather leave the commercial system as it is. We would like to change it, so I suppose we have to take the initiative.

Maybe if we can exert some consistent leadership, maybe if we can make the Europeans an offer they cannot refuse—that is, to allow them to engage in as much East-West trade as they want in certain areas but restrict certain financial aspects—maybe if we could make them such an offer the Europeans might surprise us by responding positively.

I realize I am probably being somewhat naive in expecting that this could happen, but it is at least worth having an optimal goal and trying to go maybe 30 percent toward achieving it. Otherwise, we're doomed to go on muddling through with our allies for the foreseeable future, weathering more pipeline-type crises. And every time the credibility of the United States and its ability to serve European agreement is somewhat diminished. I think I will stop there.

[Dr. Stent's prepared statement follows:]

Prepared Statement of Dr. Angela E. Stent

East-West economic relations have at various times in the postwar era been a source of contention between the United States and its European allies, but they have never played such an important and divisive role in the politics of the Western alliance as they do today. Indeed, one could argue that, given the relatively small share that East-West trade contributes to the GNP of any country, the debate over commercial relations with Communist countries has been disproportionately disruptive for Western unity. Disputes over trade reflect basic disagreements between the United States and its allies over how to interpret and respond to the Soviet threat. They also reveal how difficult it is for the United States to gain multilateral European compliance with unilateral American measures directed against the U.S.S.R. The recently-announced agreement between the United States and Western Europe to review and possibly harmonize their East-West commercial policies in return for the United States lifting the pipeline sanctions is a hopeful sign in view of these problems. Nevertheless, the underlying political and economic premises in Europe about East-West commercial ties remain fundamentally different from our own.

I have been asked to discuss West European attitudes toward East-West trade. I shall in my brief statement describe those views that are common to all major West European states, and also differentiate between the attitudes of our three main allies—the Federal Republic of Germany, France and the United Kingdom. Naturally, there are voices that dissent from the prevailing consensus within each country. Nevertheless, there has been sufficient continuity in views to outline the basic, consistent policy premises. I shall also indicate in what specific areas the Europeans might be willing to compromise with U.S. policy, and in what areas their positions seem to be non-negotiable.

EUROPEAN ATTITUDES TOWARD THE POLITICS AND ECONOMICS OF EAST-WEST TRADE

The Europeans view East-West commercial relations as an integral part of their relations with the U.S.S.R., and as an important element in the success of détente over the past decade. They believe in pursuing a dual policy toward the Soviet Union—maintaining military strength while at the same time continuing the dialogue with Moscow. Trade is an important element of the cooperative track of this two-track European policy. Moreover, the Europeans had more limited, regional expectations from détente than did the United States. From their perspective, the U.S.S.R. has observed its détente commitments in Europe, even if it has violated an American-defined code of conduct in the Third World. In their conviction that détente has worked, Europeans view economic relations as a stabilizing factor, reinforcing the Soviet Union's commitment not to disrupt the European status quo. Economic relations with the U.S.S.R. and Eastern Europe are perceived to be a normal, desirable aspect of East-West relations. It has never been a question of whether to trade with the Russians, but rather how to trade under optimal conditions.

The basic premise underlying this view, which explains the absence of debate in the European media about whether to engage in economic relations with Communist nations, is a concept of security that is different from our own. The American concept of security is overwhelmingly military in nature, whereas that espoused by the Europeans is almost equally economic. Europeans believe that East-West trade is a mutually beneficial activity, since it contributes at least as much to the economic health of Western economies as it does to the economic strength of the U.S.S.R. This is because West European economies are far more trade-dependent than is the American economy, and a healthy export sector is preceived to be one factor guaranteeing their democratic way of life.

Western Europe is quite willing to cooperate with the United States in COCOM to control exports that have a *direct* application to Soviet military power, that is, items that could be diverted to actual use in the conduct of war. However, the United States has now broadened its definitions of what constitutes a security risk to include goods and technologies that contribute *indirectly* to the conduct of war, namely exports that strengthen the entire Soviet industrial base. The United States now has a narrower definition of what contributes to national security and a broader definition of what threatens it than does Western Europe.

The disputes over the West Siberian natural gas pipeline were in large measure based on different interpretations of security. Europeans reject the American argument that all non-agricultural East-West trade strengthens the Soviet industrial base, thereby making it a more formidable enemy. They have always believed that it is in the West's interest to participate in the development of Soviet energy resources and prevent an energy crisis in the U.S.S.R., because this will increase world energy supplies and might also diminish Soviet interest in the Persian Gulf. Moreover, the Europeans argue that expanding the Soviet energy infrastructure will increase Western security by enabling Europe to diversify its sources of imported hydrocarbons and diminish its dependence on unpredictable OPEC nations.

Europeans do not believe that the West should attempt to promote an economic crisis in the U.S.S.R. nor do they believe that the West has the power to induce economic collapse in the Soviet Union. They consider a major economic crisis in the U.S.S.R. to be potentially dangerous to their security, because the Kremlin might be more tempted to flex its military muscle if it were facing major economic problems than if its economy were functioning tolerably well.

Western Europe also rejects the use of economic sanctions as a diplomatic tool in relations with Communist nations. It questions the utility of the American policy of trade denial either as a means of influencing Soviet behavior or as a symbolic gesture to express disapproval of the Kremlin's policies. Europeans particularly object to U.S. sanctions that directly affect their own economic relations with the East, because these can impose significant economic costs on Western Europe. For instance, the pipeline sanctions would have cost the Europeans far more than the United States, and yet these sanctions were unilaterally imposed by Washington.

Europeans also consider sanctions to be an ineffective tool for changing one's adversaries' policies. They argue that trade sanctions have never altered Soviet behavior on crucial political questions such as Afghanistan or Poland, even if they imposed economic costs on the U.S.S.R. Europeans have also criticized the inconsistency of American policy in the last 2 years, when the United States lifted the grain embargo, but retained the high technology embargo. Most Europeans believe that trade can only influence Soviet behavior on certain marginal political issues, such as emigration, and then only if trade is used as a carrot instead of a stick. All European countries share this view of the politics of East-West trade.

Our allies do, however, support the principle of using commercial relations to promote East European independence from the Soviet Union. Greater East-West European economic ties diminish Eastern Europe's economic dependence on the U.S.S.R. and can, it is argued facilitate some polycentrism. West European stress that the East Europeans favor more intense economic ties with the West for precisely this reason, and are very concerned about the economic implications of the current

Western questioning of détente. They do not want to be thrown back to greater dependence on the U.S.S.R.

The West Europeans emphasize that trade and joint commercial ventures with Hungary have assisted the successful development of Hungary's unique economic system, one that encourages a significant degree of decentralization and private enterprise. Hungary's successful economic policies, they argue, have enabled it to develop a political system that permits more individual freedom than does the Soviet system. West Europeans also point to Poland as an example of the effects of East-West commercial ties. They point out that Poland's intensified economic and political ties with the West in the 1970's encouraged greater individual expression, eventually facilitating the formation of the independent trade union, Solidarity. Of course, the imposition of martial law and the subsequent banning of Solidarity clearly show the limits of greater East European liberalization. Nevertheless, our allies continue to believe in the utility of differentiating between Eastern Europe and the U.S.S.R. in commercial policy.

THE PREMISES OF OUR KEY ALLIES

The Federal Republic of Germany

West Germany's East-West trade policy differs somewhat from that of the other European allies, when one moves beyond the general premises outlined above. Germany is in a unique category for largely political reasons. A divided country with Soviet troops on its borders, West Germany seeks to improve ties with East Germany and to maintain links with West Berlin. It is therefore far more dependent on Soviet good behavior than is any other West European nation. Moreover, détente has brought West Germany far more concrete results than it has any other European nation. This is largely because the Soviet Union has deliberately abided by its détente agreements with West Germany in order to reinforce Bonn's continuing stake in détente, irrespective of American policy shifts.

Economic contacts have played an important role in German-Soviet relations over the past decade, and the German Government believes that commercial ties have brought tangible results. This is why the current Christian Democratic government remains as committed to East-West trade as was the previous Social Democractic government. There is a bipartisan consensus on the need for East-West commercial ties in West Germany.

The Germans have had more experience than have the Americans in using trade as a political weapon with the U.S.S.R., and their attempts have shown that trade sanctions do not bring politicial results. At various times prior to détente, Bonn used trade denial to try and elicit Soviet concessions on Berlin and intra-German relations, and these measures failed to gain Soviet compromises.

Trade incentives have, however, worked, on more marginal issues. They have produced a variety of Soviet and East European concessions on questions such as emigration of ethnic Germans from Eastern Europe and the U.S.S.R., and on closer family ties between the two Germanies. So far, about 300,000 ethnic Germans have emigrated from the CMEA nations. Moreover, the Germans believe that the Soviets have abided by their agreement with Bonn for partly economic reasons. The U.S.S.R. needs its commercial ties with West Germany to maintain its economic growth, and recognizes that in return it must permit more humanitarian contacts between East and West Germany, even though this can have destabilizing effects.

The economic interest in commercial ties with the U.S.S.R. and other Eastern European countries is somewhat greater for West Germany than it is for other West European countries, partly for historical reasons. Russia and Germany have been trading for centuries, and there is a long tradition of interdependence between the two countries. Trade between them has always involved the export of German machinery in return for Russian raw materials.

Germany is a trade-dependent economy, with foreign trade contributing as much as 30 percent of GNP. Facing the highest postwar unemployment rate and the prospect of more economic difficulties, the German Government considers the 300,000 jobs secured by trade with CMEA nations to be significant for economic and political reasons. Moreover, trade with Communist countries is disproportionately important for certain sectors of the German economy, particularly the steel industry that is currently experiencing major economic problems. For any political party trying to win an election, it is important to promise German workers the continued employment benefits of East-West trade.

Unlike other European nations, Germany does not subsidize interest rates on credits to Communist countries, and its credit policy is similar to that of the United States. German interest rates are higher than those of other NATO countries in their dealings with CMEA. Sometimes, as in the case of the pipeline deal, the German banks charge rates of interest below market rates, but the steel corporations charge the Soviets a higher price for the equipment and then reimburse the banks for the difference between market rates and those charged the Soviets. Thus one has to examine the whole package involved in these deals, and not only the rates of interest. Government-backed export credit guarantees are available via the Hermes agency. These cost less than comparable guarantees on the open market, and do therefore represent an indirect government subsidy for credits to Communist nations. Nevertheless, the Germans have been more willing to comply with U.S. efforts to curb cheap credits to Communist nations than have other European nations.

France

The French have less of an economic stake in trade with Communist nations than do the Germans, and France is also more skeptical about the political value of such trade. France's Gaullist traditions have influenced every French Government over the past 20 years, and have meant that Paris has been committed to diversifying its international political and economic links as much as possible; has been averse to mixing economics and politics; and has resisted American attempts to influence its policy.

Under the government of Socialist President Mitterrand, France's attitude toward the Soviet Union has been closer to that of the United States than has Germany's; yet the government's critique of Soviet policy and the Soviet military build-up has not extended to restricting economic relations with the East. Unlike Germany, France is not beholden to Soviet goodwill on issues such as Berlin and intra-German relations, and is less dependent politically on the Kremlin. However, France has always found it useful to pursue a relationship with the U.S.S.R. as a means of maintaining its independence from the United States. Indeed, the most controversial East-West trade issue in France today is not what should be sold to the Communists, but whether France should support U.S. policies. The French reluctance to admit that the allies had agreed to review their East-West trade policies in return for the lifting of the pipeline sanctions reflects the French aversion to cooperating publicly with America on these issues.

France has few political reasons for supporting East-West trade, and does not claim that this trade has beneficial political results. It is, however, interested in this commerce for largely economic reasons. Since the invasion of Afghanistan, Franco-Soviet high-level political contacts have sharply declined, but trade has grown, although not as much as the French would have liked. Indeed, the French have taken over some contracts that were denied American firms after the invasion of Afghanistan. France has many of the same economic interests in trade with Communist countries as does Germany, particularly in its ailing steel sector. Moreover, the French Government subsidizes interest rates on credits to Communist nations and has stated quite clearly that it will not raise those rates beyond the OECD consensus. France grants subsidized credits to all countries, including the United States, and has refused in its credit policy to differentiate politically between countries since the mid-1960's. There is, therefore, little prospect that France will cooperate with the U.S. attempt to tighten substantially credit terms for Communist nations.

The United Kingdom

The British position on East-West trade is closer to that of the French than that of the Germans. Like France, Britain is more skeptical of the political value of trade, but it insists on its right to pursue East-West trade for economic reasons. However, one senior British official recently told me that British-Soviet relations were so bad that economic ties were the one remaining avenue of cooperative communication between the two nations. The government of Margaret Thatcher has largely supported the American position on the U.S.S.R. and is critical of détente. Nevertheless, Britain has made every attempt in the past few years to increase its exports to the East, largely because of its severe economic problems.

The British reaction to the extraterritorial U.S. pipeline sanctions highlighted the U.K.'s commitment to East-West trade. Prime Minister Thatcher made a point of showing support for the firms that were defying U.S. sanctions, and she stressed the economic reasons for the compressor shipments, as well as the question of Britain's sovereignty. The United Kingdom, like France, also subsidizes rates of interest on credits to Communist nations, and has said it will continue this practice. However, London is currently more willing to cooperate publicly with United States moves to restrict lending to the East than is Paris.

CAN THE UNITED STATES AND WESTERN EUROPE REACH A COMPROMISE ON EAST-WEST TRADE?

It is clear from this brief overview that Western Europe remains committed to pursuing commercial relations with Communist nations, even if it has differing evaluations of their political utility. The Germans have the greatest economic and political stake in this trade, but because of their close links to the United States and their greater dependence on American military protection against the Soviet Union, they are more willing to consider avenues for compromise on certain issues than are either the French or British, or for that matter, any other member of the European Community. Despite the fact that some European countries have different perspectives on East-West trade they are united against recent U.S. positions on sanctions.

Western Europe has agreed in principle to cooperate with United States in revising, updating and tightening the COCOM lists, because all COCOM members realize that they must hinder the transfer of military technology to the Soviet Union and Eastern Europe. Europeans should be willing to broaden their definitions of security. They have also cooperated with the "no exceptions" for the U.S.S.R. rule in COCOM since the invasion of Afghanistan. The United States may find considerable room for allied agreement in the COCOM arena provided it does not seek to apply too broad a definition of what constitutes a military threat. Indeed, the COCOM forum is currently the most promising avenue for securing alliance agreement on some aspects of East-West trade.

It will be more difficult for Washington to gain a viable agreement on credits. Most European countries believe that without subsidized credits, their products might not be competitive with those of other countries, for instance Japan, on the Soviet market, and subsidized credits are a basic feature of their economic systems. Trade and credit policies are not separated in Europe as they are here, and the Europeans continue to deny that subsidized credits are a form of economic aid to the U.S.S.R. They see them more as a form of subsidy to their own beleaguered industries.

Probably the most that the United States can hope for is to secure agreement on raising interest rates, providing the French cooperate, and perhaps eliciting some promise that credit volumes could be restricted. But European banks are still interested in making loans to CMEA nations, and consider the Soviet Union a good credit risk.

The major European complaint about American East-West trade policy is that it is inconsistent, unpredictable and can disrupt European markets through unilateral American actions. Indeed, one of the long-range effects of the pipeline sanctions may well be to deter European firms from entering into future licensing agreements with American corporations because they fear the possibility of future sanctions. The Europeans need stable, consistent economic ties with the East if they are to reap the economic benefits of such commerce.

The key question here is U.S. foreign policy controls. While Europeans accept the need for the National Security Controls, embodied in our Export Administration Act, they consider that foreign policy controls endanger the continuity of their trade. The ability of the U.S. President to deny licenses or cancel trade agreements retrospectively in response to Soviet actions introduces an element of instability into East-West trade that Europeans cannot support. Since U.S. actions often have a direct effect on European commerce via U.S. licenses, the allies are affected by actions taken primarily for American domestic or foreign policy purposes. If the United States wants to secure allied compromises on some aspects of East-West trade, Congress might have to consider diluting, if not abandoning, foreign policy controls as an instrument of East-West trade.

These policy questions raise painful choices for the West. If we cannot react with economic means to Soviet actions, what other levers do we possess? Since we cannot use military means, trade is one of the few available levers. The European response to this argument is to deny that economic sanctions are an appropriate response to Soviet actions because their possible symbolic value is outweighed by the economic damage they cause. Europe also questions why the United States has to react at all to certain Soviet policies. These differences of opinion are indeed profound, and lie at the heart of some of the allied East-West trade disputes. They cannot be easily resolved, but both sides will have to at least discuss them openly if some compromise is to be found.

My analysis of European premises on East-West commercial policy does not make me very optimistic that the United States and its allies can overcome their differencies, as long as the United States adopts such a restrictive approach toward nonagricultural East-West trade. Moreover, the recession in all Western economies has exacerbated disputes over East-West trade. Yet my impression from talking to European officials and politicans about these topics is that they would prefer not to keep muddling through as they have until now. There is a recognition in Europe that this transatlantic dispute must be defused and that its resolution will hinge on a discussion of the broad political and economic premises of trade, rather than the specifics, such as whether the next pipeline should be built. The pipeline sanctions have already had one beneficial effect. They have made the Europeans realize that they must reevaluate their East-West commercial policies. If the United States can demonstrate consistent leadership, insisting on certain fundamental premises, but flexible enough to accommodate some European concerns, then the alliance may be able to reach a new consensus. Otherwise East-West trade will damage Western security by undermining the alliance itself.

Moderator HARDT. Thank you very much, Professor Stent. The broader aspects of the trade issue are the subject Mr. Sloan will give his particular attention.

Stanley Sloan is a specialist in U.S. alliance relations in the Foreign Affairs and National Defense Division of the Congressional Research Service. He was educated at the University of Maine and the Columbia University School of International Affairs.

He has had a varied experience in the U.S. Government community, and among his various assignments was that of being on the staff of the Delegation on Negotiations for a Mutual and Balanced Force Reductions [MBFR] with Ambassador Dean at the time.

He has contributed to many articles on the question of the NATO alliance. One of his more recent contributions has been to the Senate Foreign Relations Committee study, "NATO Today: The Alliance and Evolution." Stanley Sloan.

STATEMENT OF STANLEY R. SLOAN, SPECIALIST IN U.S. ALLIANCE RELATIONS, CONGRESSIONAL RESEARCH SERVICE, LIBRARY OF CONGRESS

Mr. SLOAN. Thank you, John, ladies and gentlemen.

John has asked me to discuss the issue of whether differences over East-West trade policies have broader implications for the alliance. Being a Vermonter, I wondered if he would accept the Coolidge standard. You probably all know the story about Calvin Coolidge who was approached by a lady at a cocktail party who said, "I have a bet with a friend of mine that I could get you to say three words," Calvin Coolidge responded, "You lose."

In answer to John's assignment, I thought perhaps I could answer first the question of "are there broader implications?" by simply saying "yes;" and to the question of what the nature of those implications is, I could say "bad." But that was not sufficient for John, so we will operate by the Hardt standard today instead of the Coolidge standard.

The central question I have to address, obviously, is whether the recent differences with the allies over East-West trade and the way in which the administration has pursued its inclinations on this issue have made it more difficult to produce consensus within the alliance on other issues not directly related to East-West trade.

At the heart of this question is the capability and effectiveness of American leadership. It should first be acknowledged that attempting to lead an alliance of sovereign nations toward common policies in areas where there are at least mild differences, and in many cases, sharp differences, is a thankless task. U.S. attempts to guide the allies historically have been plagued by a "dammed if you do and damned if you don't" phenomena.

It has always been the case, even in the "good old days" of American preeminence, that the allies are never totally happy with the nature of American leadership. But now conditions have changed to make it even more difficult. The good old days were before the United States lost its dominant role in the international power balance. The good old days were before Europe had adopted a somewhat more feisty political attitude to go along with its growing economic proportions. And the good old days were before the Vietnam war and the Watergate tragedies undercut American leadership in European eyes.

So the requirements of leadership today are far more demanding than they were in what we refer to as the good old days. It remains true that American leadership, if it is to be effective, must be strong and consistent. These are terms we have heard frequently. We heard them in particular during the Carter administration when they were used to describe what was seen as lacking in American leadership.

In my opinion, there is also a third term that in today's world must be added to these first two. American leadership must also be convincing. It must be convincing not just in terms of how we perceive our own interests, even through leadership must eventually comply with our concept of self-interest. It must be convincing not not just in terms of how we perceive the interests of our allies, even though developing our own perception of allied interests is important to the process.

Ultimately, if we really hope someone will follow our lead and that they will wish to follow our lead in the future, our leadership must be convincing in terms of how the Europeans perceive their interests.

The Reagan administration came to office, as do most new American administrations, with a complex set of objectives. The objectives of the American administration, however, to some observers seem to include more than the usual potential for conflict one with the other.

It was unclear, for example, how the administration intended to solve some of America's economic problems while at the same time doing a major repair job on our defense establishment. It was also unclear how the administration would reestablish American leadership in the NATO alliance when it clearly intended to give a lower priority to arms control, which was a very high priority, still, from the European point of view.

So while our European allies welcomed the new American administration and its promise of renewed American leadership, some Europeans were voicing concerns that were not expressed at the official level, and perhaps a brief anecdote will help illustrate this point.

In June 1981, while on a speaking tour in a number of European cities, I was consistently met by questions about the intentions of the Reagan administration: What does this administration, with all of its very strongly held ideas, intend to do? I started out by explaining that as an employee of the Congress, I had a hard enough time figuring out what the intent of the Congress was, to say nothing of figuring out what the intent of the administration might be.

By falling back on historical precedent, I suggested most American administrations, irrespective of views candidates might have held during campaigns, tended to move toward the center, and that therefore, American policy toward the alliance might be more or less according to traditional American approaches. One questioner in the audience, however, was not totally satisfied with my attempt to reassure, and he argued that, as he called them, the "ideologues" in the Reagan administration would have a very hard time compromising with their adversaries, meaning they would have a difficult time reaching any kind of an agreement with the Soviet Union on virtually any issue.

But he didn't stop there. He continued. What was even more worrisome to him was that not only would these people have a hard time agreeing with their enemies, they would probably have a hard time agreeing with their friends. To the extent that his question or assertion was true, the Reagan administration, at least some elements of that administration, might have started out with the clear potential for disagreement with the allies, with our friends.

Now, the link between conflict with the Soviet Union and the potential for conflict with the allies was clearly demonstrated in the reaction to the Soviet invasion of Afghanistan, and both Charles Wolf and Angela Stent have talked in detail about differing American and European approaches to dealing with the Soviet Union, different perceptions about what motivates the Soviet leadership.

And I think it is important to remember that this administration came into office against the background established in the Afghanistan case. So it was no secret there were very differing attitudes and perceptions between the United States and the West European countries after this experience. The last thing the Western alliance needed was another Soviet action that seemed to require a punitive response from the West. But, of course, as luck would have it, the declaration of martial law in Poland provided just the further opportunity to put these diverging perspective to the test.

On balance, I think you have to say that the Western response to the Polish case was a bit more cohesive than in the Afghanistan case. There had been extensive consultations among the allies prior to the declaration of martial law. Granted, these consultations focused on the issue of Soviet intervention, but at least it meant that a number of the differences as well as areas of agreement had been aired within the alliance beforehand.

But the demonstration of relative cohesion in January of 1982, obviously, did not resolve the fundamental differences between the United States and Europe, and these fundamental differences reemerged once again with the U.S. decision to extend the application of the gas pipeline sanctions to West European industrial participants in the pipeline project.

The implications for the alliance of the Reagan administration's action resulted from two elements of that action: first, the way the action was taken, and second, the substance of that extension of sanctions. In the short term, the alliance is always troubled by surprises. Neither we or the allies like surprises in the alliance relationship. In this case the allies were clearly caught by surprise.

Just days after the action, I heard Chancellor Schmidt say in strong terms that he had not been forewarned of what was going to happen, not at Versailles; not at the Bonn summit; not in subsequent conversations with U.S. representatives. At the time I heard him say this, he had Richard Perle sitting to his left and Richard Burt sitting to his right, and neither of them disagreed with his assertion.

So this from the beginning created problems with the allies. A very important action was taken that was regarded as a surprise. It was regarded as not compatible with the way we do business in the alliance. Now, the surprise may have been due in part to the fact that the allies were listening largely to the State Department representatives, who may have been reflecting their own hope that the President's final decision would go the way the State Department was arguing.

Obviously, the decision went the other way. Not only did the decision go the other way, but the winners in this bureaucratic dispute made sure the announcement was available to the press very quickly so that there was no possibility of backsliding on the decision. Therefore, the State Department didn't even have an adequate opportunity to forewarn the allies in the hours before the decision was announced publicly.

Perhaps more importantly, the action convinced many Europeans that the Reagan administration was moving toward a policy of confrontation with the Soviet Union, which they found incompatible with European interests as well as with their perceptions about how to deal with Moscow. They also wondered whether the action signaled a new unilateral phase of American policy toward East-West relations.

As you know, throughout the history of the alliance there has been a consistent attempt to develop a coordinated approach toward East-West relations, and previous American administrations and the Reagan administration have attempted to formulate common policy where possible. Today, some of the damage done last summer has been undone under the quiet direction of Secretary of State Shultz. It should be clear to questioning Europeans that the United States still does hope to work out coordinated policies with its allies even though such efforts promise to be difficult and perhaps unsuccessful. Even at the peak of the pipeline controversy, there was never a question about the near-term requirement of the European allies for a security alliance with the United States. In fact, the Reagan administration probably took this into account when the decision was made. No ally is likely to alter its fundamental participation in the alliance due to an East-West trade issue.

Whether or not longer term damage has been done to the alliance remains to be seen. To the extent the differences over the pipeline and other East-West trade issues remain open wounds on the alliance, they tend to reinforce the awareness of divergences between American and European interests and perceptions.

Over the longer term, the psychology of divergence could undermine basic United States-European alliance relationships. Clearly there is an interest now, at least from the alliance's point of view, in dampening down the disagreement and rhetoric on the East-West trade issue.

Returning to my original theme, the key question is whether the credibility of American leadership has been undermined by the gas pipeline issue and by differences in general over East-West trade. 1983 will be a very important year for the NATO Alliance, and I think the most important area for credibility of U.S. leadership will be with regard to the implementation of NATO's 1979 decision to deploy new intermediate range nuclear forces in Europe while at the same time trying to negotiate limits on these forces with the Soviet Union.

The first new Western missiles are scheduled for deployment at the end of 1983 if arms control negotiations have failed to produce an agreement that limits such systems. If negotiations have not succeeded by late 1983, the key question for public opinion in Europe may not be whether there is an agreement but who is responsible for there not being an agreement.

Now, if the negotiating performance of the Reagan administration in Geneva is perceived as inflexible and unyielding, many Europeans will see this as confirming suspicions aroused by the administration's decision to extend the gas pipeline sanctions. All the NATO allies have reaffirmed their support for the President's zero option negotiating proposal in Geneva, most recently at the December 1982 NATO meeting in Brussels. But this formal support may well erode—and I suggest the signs of erosion are already evident to anyone who wants to see them—if the proposal is increasingly seen as designed to produce impasse in the negotiations and as intended to guarantee deployment of the new systems.

I might suggest one additional area where the credibility of the administration of American leadership may have been affected by the strong position taken on gas pipeline sanctions. It is a curious but, I think, understandable phenomena that a number of those who are advocating reduction of U.S. forces in Europe start by arguing that the allies are becoming dependent on Soviet gas, and therefore, do not warrant the protection our forces are giving them. So I wonder if in another area the Reagan administration may have unwittingly undercut its objectives in terms of U.S. alliance policy.

In sum, I don't think it is possible to insulate one area of alliance policy from another. It is very difficult, for example, to convince the allies to increase defense expenditures while in our domestic legislation we are including "Buy American" provisions in defense appropriation bills. It is also not convincing to talk of a coherent Western policy toward East-West trade when protectionist sentiment on both sides of the Atlantic raises the specter of a trade war.

It is perhaps too much to expect that, in a time of recession, the Western allies could actually agree on a comprehensive, coherent Western policy toward East-West trade. If this is the case, the United States may ultimately be forced to decide whether East-West trade policy should be treated as the fundamental test of the alliance or whether it should, on the other hand, be treated as an area in which differing approaches can be tolerated in the interest of allied unity on central security issues.

Thank you.

[Mr. Sloan's prepared statement follows:]

PREPARED STATEMENT OF STANLEY R. SLOAN

BROADER IMPLICATIONS OF TRADE ISSUE FOR U.S. RELATIONS WITH THE NATO ALLIES

Most of this conference focuses on the issues directly related to East-West trade policy. My assignment is to discuss some of the connections between these issues and other areas in which the United States hopes to develop or maintain coordinated, or at least parallel, policies with the other NATO allies. Unlike some other presentations for this workshop, there are no facts that can prove assertions that this assignment appears to require. The central question is whether recent differences with the European allies have made it more difficult to produce consensus within the alliances on other issues. At the heart of this question is the credibility and effectiveness of American leadership.

It should first be acknowledged that attempting to lead an alliance of sovereign nations toward common policies in areas where interests diverge at least mildly, if not sharply, is a thankless task. U.S. attempts to guide the NATO alliance have historically been plagued by a "damned if you do and damned if you don't" syndrome. This was so even in the "good old days" before the United States lost its dominant role in the international power balance; before Europe adopted a somewhat more feisty political character to match its growing economic proportions; and before the Vietnam and Watergate tragedies undercut American leadership in European eyes.

The requirements of leadership have become far more demanding. It remains true that American leadership, if it is to be effective, must be strong and consistent—two terms that frequently were used on both sides of the Atlantic to characterize what was missing in the efforts of the Carter Administration. But in my opinion, there is a third term that, in today's world, must be added to these first two. American leadership must also be "convincing." It must be convincing not just in terms of how we perceive our interests—even though it must finally comply with our concept of self-interest. And, it must be convincing not just in terms of how we perceive the interests of our allies—even though leadership requires us to form such perceptions. Ultimately, if we hope that someone will follow our lead, and will wish to do so in the future, our leadership must be convincing in terms of how Europeans perceive their own interests.

The Reagan Administration came to office, as do most new American administrations, with a complex set of objectives. The objectives of the Reagan Administration, however, appeared to some observers to include more than the usual potential for conflict with one another. It was unclear, for example, how the Administration would be able to solve this country's economic problems while simultaneously financing a major repair job on our defense establishment. It was also unclear how the Administration would re-establish American leadership of the NATO alliance, a role which it claimed the Carter Administration had squandered, when a policy area of high importance to the West European allies—arms control—was to be given a lower priority.

While our European allies welcomed the new Administration and its promise of renewed American leadership, some Europeans felt concerns that were not expressed at the official level. Perhaps a brief anecdote will illustrate this point. In June 1981, I visited a number of European cities as a speaker for the United States International Communication Agency. I was consistently greeted by questions about the intentions of the Reagan Administration. After explaining that as an employee of the Congress I could only guess what the Administration intended, I often suggested that, using past experience as a guide, one could judge that the more extreme views of individuals within the Administration would eventually be moderated by the demands of day-to-day business; that American policy would in most areas take fairly traditional lines, particularly with regard to the NATO alliance.

One questioner, however, was not satisfied with this attempt to reassure. He argued that the "ideologues," as he called them, in the Reagan Administration would have a hard time compromising with their adversaries—meaning that they would find it very difficult to reach agreement with the Soviet Union in virtually anything. But he didn't stop there. "What is worse," he continued, "is that these people will also find it very difficult to compromise with their friends." To the extent that this observer was correct, therefore, the Reagan Administration started out with the clear potential, and even inclination for, conflict with the allies.

The link between conflict with the Soviet Union and the potential for conflict with our allies had clearly been demonstrated by the differing United States and European responses to the Soviet invasion of Afghanistan in 1979. The United States, led by President Jimmy Carter, interpreted the intervention as a clear violation of the ground rules essential for an American policy of cooperation with the Soviet Union. The Soviet aggression was also seen as a potential threat to Western interests in the Persian Gulf area. In Europe, the invasion was seen by many as a defensive Soviet reaction to instability on its periphery. Few Europeans interpreted the action as a direct threat to European security, and few were willing to risk the real gains of détente in Europe in order to punish the Soviet Union for its aggression against Afghanistan.

Furthermore, the Afghanistan experience demonstrated that Europeans and Americans hold somewhat different beliefs about the effectiveness of various policy tools for dealing with Soviet misbehavior. The response revealed a certain American belief that trade sanctions could be used to punish the Soviet Union and, perhaps, to influence future Soviet behavior. In Europe, for reasons that other speakers have outlined, the potential for trade sanctions to advance Western interests was regarded with greater skepticism.

In sum, the disagreement over the Western response to the Soviet invasion of Afghanistan resulted from diverging interpretations of what motivates the Soviet leadership; and, secondly, from diverging beliefs about which responses to the Soviet action would most effectively serve Western interests.

After this experience, the last thing the Western alliance needed was another Soviet action that required a punitive Western response. As luck would have it, however, the declaration of martial law in Poland provided just the further opportunity to put these diverging perspectives to another test.

On balance, it must be said that the initial Western response to the Polish situation reflected significantly more cohesion than had been the case over Afghanistan. In spite of the numerous warts on this facade of unity, the Alliance needed to be able to say, at least, that it had developed a more-or-less coordinated response. But the demonstration of cohesion in January 1982 did not resolve the two basic differences in United States and European approaches to dealing with the Soviet Union, and those fundamental differences re-emerged once again with the U.S. decision to extend application of the gas pipeline sanctions to West European industrial participants in the pipeline project.

The implications for the alliance of the Reagan Administration's action derived from two factors: first, the way in which the action was taken; and, second, what the substance of the action once again revealed about differing perceptions of how to deal with the Soviet Union.

The short-term causes of strain originate largely in the handling of the sanctions. The allies were caught by surprise when the sanctions were extended in the wake of the Versailles summit. West German Chancellor Schmidt claimed that the Administration had not signaled its intentions at the Versailles economic summit (June 4-6, 1982), at the NATO summit in Bonn (June 10, 1982), or in subsequent allied consultations. The allies were well aware of the Reagan Administration's strong misgivings about the pipeline project, but were given to believe that the United States would not risk a direct confrontation over the issue. "Surprise" is not a unique element in U.S. relations with its allies, but it is always unwelcome and taken as a sign of less-than-total commitment to the idea of meaningful consultations in the alliance. (It should be noted that the allies have themselves broken the consultation rules from time to time in the past; it is simply a fact that when we rock the consultation boat, it makes larger waves.)

It may be that the surprise resulted in part from the fact that the allies probably were listening primarily to their State Department counterparts who may have been reflecting their own hope that the President's final decision would go their way. And, the "winners" in the bureaucratic competition rushed to make the decision public apparently hoping to forestall any possible backsliding. As a result, the United States was not even able to inform the allies of the decision prior to the announcement in order to soften the blow. From the point of view of the allies, this was not only a failure of alliance consultations but also a breach of alliance etiquette!

Perhaps more importantly, however, the action convinced many Europeans that the Reagan Administration was moving toward a policy of confrontation with the Soviet Union which they found incompatible with European interests as well as with European perceptions of how to deal with Moscow. They also wondered whether the action signaled a new unilateral phase of American policy toward East-West relations.

Today, some of the damage has been undone under the quiet direction of Secretary of State Schultz. It should be clear to questioning Europeans that the United States still hopes to work out coordinated policies with its allies, even though such efforts promise to be difficult and, perhaps, unsuccessful. And, even at the peak of the pipeline controversy, the differences did not remove the fundamental near-term requirement of the European countries for a security alliance with the United States. In fact, the Reagan Administration presumably took this factor into account before risking the direct confrontation. No ally is likely to alter its fundamental participation in the alliance over an East-West trade issue.

Whether or not longer term damage has been done to the Alliance remains to be seen. To the extent that differences over the pipeline and other East-West trade issues remain open wounds on the Alliance, they will tend to reinforce awareness of divergent United States and West European interests. Over the longer term, this psychology of divergence could undermine basic U.S.-European alliance relationships.

Returning to my original theme, the key question is whether the credibility of American leadership has been undermined. The United States may desperately need all the credibility it can get this next year with regard to implementation of NATO's December 1979 decision to deploy new intermediate-range nuclear forces while simultaneously negotiating limits on such forces with the Soviet Union. The first new Western missiles are scheduled for deployment by the end of 1983, if arms control negotiations have failed to produce an agreement limiting such systems. If negotiations have not succeeded by late in 1983, however, the key question for public opinion in Europe may not be whether the negotiations have failed, but why they have not produced agreement.

If the negotiating performance of the Reagan Administration is preceived as inflexible and unyielding, many Europeans will see this approach as confirming suspicions aroused by Administration's decision to extend the gas pipeline sanctions. All the NATO allies have re-affirmed their support for the Administration's "zero-option" negotiating proposal in Geneva. But this formal support may erode if the proposal increasingly is seen as designed to produce impasse, thereby guaranteeing deployment of new systems.

In sum, it is impossible to insulate one area of alliance policy from other areas. It is very difficult, for example, to convince the allies to increase their defense expenditures while the United States enacts "buy American" provisions in defense appropriations bills. It is not convincing to talk of a coherent Western policy toward East-West trade when protectionist sentiments on both sides of the Atlantic raise the specter of a trade war. It is perhaps too much to expect that in a time of recession the Western nations can agree on a comprehensive, cohesive trade policy toward the East. If this is the case, the United States may ultimately be forced to decide whether East-West trade policy should be treated as a fundamental test of the alliance, or as an area in which differing approaches can be tolerated in the interest of allied unity on central security issues.

Moderator HARDT. Thank you very much, Dr. Sloan.

Mr. Reichert will complete our panel. He is with Brown Brothers Harriman, a merchant bank in New York. He did his undergraduate work at Harvard University and his graduate work at the Stanford Graduate School of Business. Recently a Trilateral Commission study entitled "East-West Trade at a Crossroads," including contributions by Americans, Germans, and Japanese, was released. Robert Roosa, Michiya Matsukawa, and Armin Gutowski represented the various national elements. Mr. Reichert is the associate author of this volume and brings to us not only the experience of dealing with this broad aspect of a unified policy of East-West trade but also has given his attention, since we asked him to participate in this panel, to developing new approaches in the very current context.

Thank you for joining us.

STATEMENT OF WILLIAM M. REICHERT, BROWN BROTHERS HARRIMAN & CO., NEW YORK, N.Y.

Mr. Reichert. I would like to point out that even though Brown Brothers Harriman is the only representative in this panel of operational capitalism, we do not have any loans outstanding to any Eastern European or Soviet country, so we don't have any specific ax to grind.

But in any case, I came to this subject through the Trilateral paper John mentioned. The idea of the paper was not so much to assemble experts who could then rehash the issues and theories, but to assemble people who are almost specifically not experts, but who have training in finance and economics and exposure to what I refer to as operational capitalism, and to try to sift through all the descriptions and theories and comments of the experts and come to some sort of an idea of a unified policy perspective.

In the process of the whole study, I share the frustration that Drs. Stent, Sloan, and Wolf have pointed out, the frustration of not being able to find answers easily. Nevertheless, I am going to do a little wing-walking today and see if we can try to at least identify some specific directions to take and at least throw them out to be chewed upon, if not chewed up.

But by way of introduction or overview, one of the things we noticed in surveying the current problems is that despite the fairly significant amount of acrimony that has passed across the Atlantic and across the Pacific—we should not exclude Japan from our discussion—it does not seem at the policy level the debate has really been joined. It is frustrating because panels like this, where we are all fairly openminded and moderate people, seem to come to some sort of consensus, so why the heck isn't it operating at the policy level?

Obviously, and I think Dr. Sloan went through this very well, there are a lot of other issues that divide the allies other than these, such that pure rationalism will not guide policymakers to a solution. Instead what has happened is, as the debate is not joined and as the arguments have been tossed across the ocean, there has been a fragmentation of the consensus of the the alliance that has been quite destructive, I think, rather than constructive.

Over time the United States, as the centerpiece superpower of the alliance, rather than being perceived as a leader, the United States is perceived, in the imagery of Raymond Vernon, as a rogue elephant bashing about somewhat mindlessly in the woods and causing more damage than providing leadership. I should point out that Professor Vernon's imagery was presented in a paper 10 years ago, so this image of Europe of the United States is not exactly new. This is not the first crisis the alliance has met, it won't be the last, and hopefully, the alliance will survive.

In any case, I think the particular circumstances of the last month have created an environment that is particularly ripe for the United States to undertake some new initiatives. The transition in leadership in the Soviet Union, while not necessarily leading to a transition of Soviet policies, nevertheless forms a rather unique sort of window through which we can try, to some extent, to start over without losing as much face as we might if the Soviet leadership were not in transition.

I think it is very significant and not merely coincidental that some of the initiatives that have taken place recently have taken place in this period, and I hope these are indeed first steps toward a larger initiative rather than evasive steps going back to where we were before. It is distressing that when the allies get together these days, the only solution seems to be to study things. So we get panels and the panels come to a consensus, but it is not clear that this leads back to policy.

What I would suggest as an operational approach is that indeed there is still a role for economic sanctions—we can't reject their possible use altogether—but that the alliance should find a common ground in the use of sanctions at a very limited level. Combined with that, I think the COCOM mechanism can provide, as Dr. Stent pointed out, the most hopeful ground of unity within the alliance. COCOM still has a role, but it should have a more narrow focus.

Ultimately the allies should work toward a common framework for dealing with East-West trade constructively, in a manner that will satisfy the political objectives of each. Such a framework should focus on promoting trade within the bounds of prudence outlined by COCOM and by the appropriate use of sanctions. That sounds rather ambitious, I realize, but let's take a shot at it in any case.

The question of how you get the allies together in the use of sanctions: I first want to focus on the non-COCOM aspects of sanctions. I think in looking over the debate, that a lot of the debate on sanctions has been misplaced, that there has been a fair amount or too much debate on percentages of GNP related to trade, percentages of trade in a given sector, meat consumption by kilogram per capita in the Soviet Union—a lot of economic statistics which are important but not necessarily the real measure of the appropriateness of sanctions, as other members of the panel here have pointed out.

The importance of sanctions is not so much their real economic impact; the importance is what their effect is on the behavior of the Soviet Union and the CMEA. So in evaluating sanctions, it is not necessarily the most useful approach to say, well, this specific economic sector is in fact the most representative of Soviet dependence on the West and therefore that is our best lever, because economic dependence alone will not necessarily mean a shift in Soviet behavior.

The problem is that if you attack a sector that is considered important to the Soviet Union and try to use that as a source of economic leverage, you can guess that the Soviets will go out of their way not to appear to be levered by your using sanctions in that sector. So what do you do instead?

I think the better measure of sanctions is not so much real economic dependence; rather, the most important issue in sanctions is the sensitivity of each side. If you look at it this way, the tables turn, because in the case of a lot of the sanctions that have been attempted in the past, it turns out that in fact the West is more sensitive to these economic sectors than is the East.

Grain is probably the best example of that. If you want to discuss the impact of grain on the Soviet Union, you also have to discuss the impact of grain on the West, and I think history has shown that the West, and particularly the United States, is more sensitive to a grain embargo than is the East. That is the key to the failure of such sanctions. In this light, the Afghanistan sanctions need to be reevaluated.

The proponents of the Afghanistan grain embargo argue, well, it would have worked if we had just had everyone together, because grain is the most sensitive sector of the Soviet Union. The problem, they argue, was not that we shot ourselves in the foot, but that our allies shot us in the foot.

On the other hand, some complained that the Olympic boycott, for example, was a ludicrous effort—that it was absurd because the Olympics are not a particularly important economic sector of the Soviet Union.

I think in retrospect perhaps we can reevaluate the Afghanistan sanctions and consider this possibility: that the most effective approach in that case might have been, say, a short-term, cooperative grain embargo and a more focused effort on getting the allies to agree to a complete Olympic boycott. As it was instead, the West lacked a common framework for trying to convey its message to the Soviet Union. The result was the United States could not get a whole lot of agreement out of the allies, and the only message conveyed to the Soviet Union was that, in fact, the allies do not stand together in their point of view on Soviet behavior.

If you can find an approach that the allies can afford—and I think that is one of the reasons Germany was willing to go in on the Olympic boycott, that the boycott was relatively cheap—you might find a basis for a consensus agreement on the application of these economic sanctions on a limited scale.

The approach, then, that I would recommend on the use of sanctions is first to try to take a carrot as opposed to a stick approach. There are, as Dr. Wolf pointed out, elements of incentive that are involved in what he defined as economic warfare that provide positive gains in the process of negotiating with the Soviet Union. For example, at the moment, the Soviets would like greater assurances of the sanctity of contracts. I would suggest that the Western allies should get together and try to negotiate this point on a mutual basis rather than allowing the Soviet Union to particularly pressure the United States or particularly pressure any one country individually into granting that in a situation where the individual country has fairly little leverage, because without granting sanctity of contracts, they are guaranteed Soviet sanctions.

As was pointed out by one of my colleagues, state trading is indeed a form of economic warfare. The Soviets do, in fact, apply economic sanctions. It is not unique to the West. The Soviets are constantly applying those economic sanctions on the United States. We should be aware of that. But that doesn't mean that you fight sanctions with sanctions. We should seek to take advantage of a more unified allied front in negotiating incentives with the Soviet Union rather than individual countries seeking to lash out independently.

Now, backing that up is the suggestion that the allies agree upon the possibility of using coordinated, limited economic sanctions over a temporary period in the case of egregious Soviet violations of what is considered Western interests. Obviously, that gets into a whole realm of problems, but I think we have a model of sorts in the Falklands case, where the EEC [European Economic Community] applied 30-day sanctions against Argentina.

Now, I don't want to compare Argentina to the Soviet Union, but I think the important point is that the European allies were willing to agree on economic sanctions. You had the whole EEC getting together and applying a sanction. That was a fairly unique agreement in the past 2 years, and one the United States has not been able to get out of the allies. I think the significance was, again, that those sanctions were not particularly costly to the Western allies, but I think such agreement does have value to the Western allies because it showed a certain amount of unity. We should not disregard the importance of symbolism in the application of sanctions.

If the Western allies can be shown to be acting together and can convey through sanctions information to the Soviet Union as to what Western interests are and combine that with diplomacy, I think you will have a far more effective impact on Soviet behavior than if you try to, as they say, bring them to their knees.

With regard to specifically COCOM, I think Senator Mathias' article, which I read on the plane coming back from London yesterday, said pretty much all that I wanted to say, so I would recommend it heartily to you. He develops six principles of a common policy on COCOM, and his point is that basically you should recognize there are limits to the ability to restrict the technological development of the Soviet Union.

Clearly, from an operational point of view using COCOM as a rapid deployment force for economic sanctions the way the United States has tended to do severely damages not only the operational capability of an institution like COCOM, but its credibility and its legitimacy within the alliance. Rather, a more narrow focus—of course, there are technical difficulties—but the more narrow focus would be much more useful, realizing that no matter what you do, there is going to be leakage. You have to accept that.

But in thinking about the role of COCOM, let me pose to you a little thought experiment: Imagine that the United States and the Western allies, through commercial trade, actively sought to try to assist the Soviet military capability.

I would contend that it is very unlikely for two reasons that open trade of commercial technology with the Soviet Union would significantly, if at all, increase the threat of the Soviet military. The two reasons are: One, it seems the Soviets are not particularly good at absorbing commercial technology. (They have demonstrated a capability of developing good military technology, and I don't want to ignore that.)

But second and more important, the threat of the Soviet military, I would contend, is much less dependent upon their technical capability than it is dependent upon the strength of the alliance and the relationship between the Western allies and the Soviet Union.

So if you really want to get to the problem of the Soviet threat, you should look at the points where you can most affect it; and I think the points where you can most affect the Soviet threat are in the relations between the Soviet Union and the Western allies, and in relations within the alliance, not through commercial trade.

Finally, there are a whole number of other areas of economic relations that have been discussed up here with regard to credit and trade subsidies. In response to Dr. Wolf on the problems of subsidies, it is not at all clear that subsidies, active government subsidies, are responsible for a lot of the trade between Western corporations and the Soviet Union. The structural distinction between trade with the Soviet bloc and elsewhere, the fact that trade is arranged through specific negotiation rather than open market exchange, makes the economics of trade with the Soviets different. Mainly, you can price discriminate with the Soviet Union, or looked at another way, you can price discriminate with your allies such that a German steel company or a French manufacturing company can at a profit sell equipment to the Soviet Union at a much lower price than they can sell it to the West, if they are using marginal productive capability that they would not be using otherwise.

So I'm not sure, Dr. Wolf, that government initiative alone is responsible for trade with the East. Elimination of government subsidies won't necessarily diminish trade with the East. While I agree that governments should eliminate subsidies, as you can tell from my remarks, I do not favor diminishing trade.

In any case, as a multilateralist, I would prefer to pursue the specific issues of broader trade in this multilateral forum, by question and answer.

Thank you.

[Mr. Reichert's prepared statement follows:]

Prepared Statement of William M. Reichert

Rarely in the course of events is there a convenient and timely occasion for a superpower to remedy the policy failures of the past and undertake a new course. Generally the press of domestic politics and the momentum of international commitments limit the scope for broad initiative. Nevertheless such an opportunity for initiative has now presented itself simultaneously to both the United States and the Soviet Union. The transition in the Soviet leadership affords both the East and the West with a chance, at least briefly, to put aside confrontation and seek progress in those areas of mutual interest that have recently been neglected.

This was the meaning of détente—an agreement that competition need not be confrontational. At one point not too many years ago, the Western nations,[1] led by the United States, all agreed that economic and other relations with the East could be safely expanded to the benefit of all involved. In the interim, however, much has happened to anull that agreement. But the concept of détente has not died in the West; rather the United States has moved away from many of its allies to an increasingly isolated position. It is a striking indication of the divergence of attitudes within the alliance that détente, still at the center of most Western governments' policies toward the East, is widely considered in the United States to be a naive or foolish concept.

The divergence of views on trade relations with the East has become a particularly divisive source of friction in the West. But despite a fair amount of discussion, there has not been a true joining of the debate over the proper commercial posture of the West toward the Soviet Union and its East European partners. The following comments attempt to sort through some of these issues and find a common ground where the Western allies might meet.

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[1] "Western" is merely a convenient, if not geographically accurate label within which I mean to include Japan.

The conclusion of this analysis is that the United States has much to gain, and little or nothing to lose, from making a commitment to fostering a constructive environment in which trade may be allowed to grow, as long as it is within bounds of prudence and is to the advantage of the West as well as the East. Specifically, this would mean (1) seeking a common understanding with its allies on the broad principles of trade with the East and the individual interests of each ally; (2) severely limiting the use of economic sanctions as a political weapon; and (3) accepting the limited focus appropriate for the control of strategic exports through COCOM. These comments provide only a very brief outline of these issues.[2]

I. CONSENSUS AND ALLIANCE

The West European countries, Canada, and Japan each pursue specific national interests in economic relations with the Soviet Union and the East European countries, as does the United States. Often this means that the Western allies are in competition with each other, for the benefit of the East. This has put serious strains on the alliance, as the United States tends to call upon the alliance to support interests—from embargoes to credit restraints—which are not always considered sufficiently vital to the allies to warrant support. Attaining a balance between national and collective interest is extraordinarily difficult when the two do not always converge, and conflicts within the alliance have erupted when members assert the priorty of national interests over the collective.

The United States, as the superpower centerpiece of the alliance, tends to think of itself as the guardian of the collective interest, sometimes rightly, sometimes wrongly. Frequently, the U.S. administration chides what it perceives as the narrow pursuit of self-interest among allies. But while sovereign interests do not justify abrogation of responsibility to the alliance, neither does the alliance have the inalienable right to intrude upon sovereign interests, and attempts to do so may damage the fabric of legitimacy that holds the alliance together.

Recent conflicts within the West have damaged the consensus needed to move toward a more compatible set of policies. The United States, pursuing unilaterally its concept of a political-economic strategy, is sometimes perceived by its allies to be behaving like a "rogue elephant," to use the analogy of Professor Raymond Vernon.[3] This has incited the development of the opinion in Europe, though fortunately still a minority view, that the United States is a greater threat to peace than the Soviet Union.

This unfairly acquits the West Europeans of some of the blame. The combination of economic and political distresses in Europe have prompted some governments to pursue their own unilateral and sometimes questionable trade policies with the Soviet Union. It is also important to point out that the Soviet Union is no innocent bystander in the game of competitive trade. With its state-run economy, the Soviet Union can very easily and quietly discriminate against buyers and sellers without taking the sort of highly visible actions a Western government must follow to control commerce. Thus, to impose economic sanctions on U.S. grain exporters, the Soviets need simply stop buying. If, on the other hand, the Soviet economy were open, the United States would undoubtedly be selling much more grain to the Russians.

As it stands, the leverage that Eastern monopsonies can extend over competing Western firms has contributed to the fragmentation of Western economic policy, and has frequently resulted in subsidized exporting to the East. Fortunately, there has been some recognition recently of the value of a more coordinated Western position on such items as credit. Certainly the West will benefit from continued efforts to rebuild a realistic consensus.

II. TOWARD A UNIFIED APPROACH TO SANCTIONS

The debate on sanctions has been remarkable in the failure of either side to truly respond to the other. Proponents of economic warfare argue that sanctions are safer than a "hot" war, that they have a deterring effect, and that they would have an even greater effect if only all of the allies would participate. Opponents of sanctions argue that they have no positive effect on the conduct of an adversary, and instead impose unnecessary costs on our own economy and accelerate the disintegration of the alliance. Sorting through the arguments more carefully suggests that, given the current approach, the nays have it. But there is still a role for a limited sanctions policy.

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[2] For a more extensive analysis of these issues, and a discussion of specific sectors of potential trade, see "East-West Trade at a Crossroads" (New York University Press, 1982), by Robert V. Roosa, Armin Gutowski and Michiya Matsukawa, with William M. Reichert, associate author.

[3] "Rogue Elephant in the Forest: An Appraisal of Transatlantic Relations," *Foreign Affairs*, April 1973, pp. 573-587.

On the effectiveness of sanctions: There really is no question that sanctions have an impact. Whether or not they yield a measurable change in the Soviet economy, however, is not as relevant as the information sanctions convey to the Kremlin. Therefore no matter what the real economic impact, it is highly uncertain that the impact on Soviet conduct is constructive to Western interests. Indeed, such a positive outcome is highly unlikely as long as the sanctions are in place, for it is critically important to the Soviet leadership not to appear subject to Western pressure.

Given the nature of the Soviet leadership and the comparative insensitivity of the U.S.S.R. to external economic forces, the proper role of sanctions should be informative: to serve notice that the West considers an issue to be important to its interests, and is willing to endanger certain benefits to assert those interests. In this regard, the Western reaction to the Soviet invasion of Afghanistan at the end of 1979 has been inappropriately evaluated. Most of the debate has been focused on highly uncertain analyses of Soviet feed grain imports and consumption, while the semi-aborted Olympic boycott is dismissed as ludicrous. In retrospect, it appears likely that the best response would have been a temporary but comprehensive grain shut-off combined with a more complete Olympic boycott. This would have effectively carried a message to Moscow at the least cost to the West, both in terms of political cost as well as economic cost.

The fact that the West had not adequately forewarned the Soviet Union about Western concerns in Afghanistan and South Asia reflects a failure of the diplomatic process. Diplomacy should not be excluded as a viable alternative to economic warfare.

On vulnerability and dependence: Certainly, there is no doubt that the Soviet Union is in some sense economically dependent on the West. The important issue, however, is not the U.S.S.R's economic vulnerability—rather it is the Soviet leadership's sensitivity to this dependence. One can debate the percentage of Soviet GNP accounted for by imports and exports. But, as the Little Prince learned from the Rose, "What is important is invisible to the eye."

Looked at this way, the tables are turned on the West. Due to the open structure of their political and economic systems, the Western nations are in certain ways more dependent on the Soviet Union and Eastern Europe, as markets for exports, than vice versa, because the West is more sensitive to economic fluctuations. Thus, a grain embargo was more painful for the United States than for the Soviet Union. Conversely, the Soviets would never allow their banking system to become subject to the types of pressures the West has endured in Poland for the sake of free enterprise. Contrary to some commentaries, the East is not the only side that can be threatened with the credit weapon.

This is not meant to imply that sanctions are not or cannot be painful to the U.S.S.R. But almost invariably, sanctions will be more costly to the West than to the East, once both political and economic costs are taken into account, including the cost of disruption within the alliance.

A unified Western approach: The use of economic sanctions is a negative sum game—everyone loses. Instead, economic carrots could be combined more effectively to provide benefits to all parties. For example, the Soviets currently would like to be guaranteed the sanctity of contracts. This should be negotiated within the OECD and offered contingent upon economic guarantees from the U.S.S.R.

In reserve, however, should be an agreement among Western countries to be willing to impose short-term, limited embargoes on new contractual commitments in the event of egregious violations of Western interests. Such embargoes, lasting only 60 days, for example, would serve two important functions: (a) serving notice on the Soviets that the West is united in opposition, and (b) satisfying the need within the alliance of demonstrating a unified response. Sanctions cannot be eliminated altogether, but by limiting their use, they become a more constructive threat. Such an approach would provide a stable environment for ongoing trade and would help to mend the fabric of the alliance.

III. TOWARD A UNIFIED APPROACH TO STRATEGIC EXPORTS

The United States has tried to turn COCOM into a rapid deployment sanctions committee, when it should be a consistent, long-term approach to controlling the transfer of the most sensitive technology directly relevant to military application. Items should not be included, or excluded, to suit political whim.

But even in the ideal, COCOM would be far from perfect. The open societies of the West simply will not be able to prevent the Soviets from acquiring sophisticated commercial technology. Indeed, by the time a technology is available locally in a few countries, it is virtually in the public domain. Though Western governments and firms can increase the cost of outsiders acquiring high technology, it would probably require an even greater expense and would not eliminate the leakage.

Before worrying excessively about this leakage, consider the situation from a different perspective. Imagine that the West made a concerted effort to assist the Soviet military by exporting sophisticated commercial technology. Given the current Soviet commitment to a strong military, it is unlikely that any amount of trade in high technology would significantly increase the threat of the Soviet military beyond what it would be otherwise. On the other hand, the most significant factor increasing the threat of Soviet military strength is the fragmentation of the Western alliance.

This does not mean there is no role for COCOM. It should monitor the development of Soviet technology and prevent the transfer of sensitive military technology from the West. And despite the comments above, it is prudent at least to delay Soviet acquisition of the most sophisticated commercial technologies.

Nevertheless, COCOM can and should substantially narrow the range of items it tries to control. Attempts by the United States to extend COCOM beyond this scope merely weaken COCOM's effectiveness and cast doubt on its legitimacy.

IV. CONCLUSION

Though it may seem paradoxical, in the short run, time is on the side of the Soviet Union. The political system of the West demands that intiatives be formulated, implemented and succeed in 2 to 4 year time spans. In negotiations subject to political scrutiny, the Soviets exploit that pressure on Western officials. Still, the gains the East might make from exploiting the structure of the Western political and economic system are unlikely to outweigh the costs of trying to sustain their system over the longer time frame. In the interim, however, the West's strength, namely its political and economic system, is its weakness. The best defense in this situation is to develop a more collaborative economic policy framework, through which the West can seek the advantages of trade with the East. These advantages may extend to more stable political relations as well as economic benefits.

It is unfortunate that the somewhat romantic notion of détente that took hold in this country a decade ago led to illusory expectations of rapid Soviet reform. But the process of building a more secure global environment is a long one, perhaps requiring a generation or more. Rapid policy fluctuations cannot but slow this process. Sound initiatives at this moment of opportunity can, however, accelerate it.

Moderator **Hardt**. Thank you.

Let me pose some general questions to start the discussion.

One question that has come through several of the discussions is the question of how actions might be coordinated among the various Western countries. And the point alluded to by Professor Stent in response to the proposals of Dr. Wolf could be posed in the following way.

Are we asking or would we be asking the West European countries to change the normal way they engage in trade throughout the world, including the East, in order to follow a desirable policy, specifically in reference to credit and trade?

If one looks at the normal trade pattern of the Japanese, for example, there is a quite different pattern of engaging in trade than is characteristic of U.S. trade. This may be viewed, and I think in Dr. Wolf's presentation one might argue, it is a view that is inherently preferential. And, therefore, it is important to raise the question of whether or not this is a factor in the development of a common policy.

The discussions, particularly of Mr. Reichert, raise the questions that we have discussed in previous panels, and that is, what are the advantages and costs of our policy to date, specifically relating to embargoes and sanctions. He brings back to our discussion the consideration of appropriate use of sanctions and embargoes and raises the question of how we can effectively use them in the conduct of trade and diplomacy. And one element of this that is suggestive is that before the Afghanistan invasion very many people felt, perhaps including those in Moscow, that we would not react as we did, and certainly we would not react in terms of limiting trade that was costly to us; namely, the grain trade, and that we would not, faced with the Olympics coming up in this country, endanger our own Olympics by putting Olympic sanctions into our reaction.

Therefore, we may have, looking at the side benefits, the possibility of a more credible "club in the closet" approach; namely, a demonstrated willingness to use under certain circumstances embargoes or sanctions, whether or not we choose to use them in the wide range of activities or whether or not we choose in the conduct of the Export Administration Act to restrict foreign policy trade criteria.

We also may have by our actions on the pipeline indicated to the Europeans and Japanese that the issues we are discussing are indeed very serious, and that we do want to get on with it in terms of developing an agreed policy. This is sometimes referred to as "the two-by-four approach." It may not be desirable in the conduct of diplomacy, but in retrospect we certainly have our allies' attention. Having that, we may find constructive uses of it; namely, serious discussions in the months ahead.

On the question of effectiveness, looking at the Soviet Union, it is implied in our discussions, although it was discussed in some detail in the second panel, that the Soviet import policy is one that is substantial, may expand, and there are important areas of dependency or vulnerability.

However, one could raise the question as to whether or not the market share of the United States in grain in a good weather year, next year might fall to zero, and whether or not the U.S. role in industrial exports also might approach the bottom line of minimal trade, and therefore raise the question of the range of options in our policy based upon an expectation of the two-sided aspects of trade.

And if this is a negative assessment, then perhaps the consideration of a unified policy becomes even more enhanced, and the positive sum game approach as suggested by Mr. Reichert might be more appropriate to give consideration to.

There are two additional elements. One is the question of Soviet alliance policy. We have dealt with Poland. We have dealt with other issues. What is our assumption on alliance policy for the Soviet Union? Some have suggested that actions taken vis-a-vis Poland that are adverse to Polish economic performance are therefore adverse to Soviet economic performance and interests. Is that a viable proposition, or in the broader sense, what are we trying to do with our policy of relations with the East as differentiated between the Soviet Union and the other Eastern countries?

Likewise, the question of alliance policy raised by Dr. Sloan raises the inference that there are many issues on which we have a quite different perception of costs and benefits than the other major allies. This was also raised by Professor Stent. Is there, in effect, an exchange range on these issues that relate to each other; in fact, is this the way it works? If we support a European position, a German position in the economic area, will this affect the placing of nuclear weapons? If you took your other issues, are these perceived, in fact, in diplomacy as tradeoffs? Do we, in effect, have to consider this range of issues that you identified and think of them in terms of exchange rates. Then when we assess costs, we may want to concern ourselves with whether or not by gaining in one area we may be losing in another area which, upon reflection, may be too serious a loss for us to want to undertake. I think that is a sharpening of the point you made, and I would appreciate your reaction.

Dr. Wolf, I know you have a very tight time schedule, and as you were the first in the agenda—he has the lure of California drawing him back—and I want to be sure to give you an opportunity.

And, Angela, I see that you are ready.

Dr. STENT. Do you mind if I just ask one question?

Dr. WOLF. Sure.

Dr. STENT. It's a very good point for Mr. President to say maybe we could agree with the Europeans on limited economic sanctions when we all think that Soviet behavior threatens Western security. But on the last two major issues, Afghanistan and Poland, we have disagreed with the Europeans over whether this is a threat to Western interests or not.

The Europeans tended to view the Soviet invasion of Afghanistan as something that should be put in a North-South or East-South context and not as an East-West conflict. We tended to view it as a United States-Soviet issue. The Europeans said why don't we stress the fact that this is an issue between the Soviet Union and the Third World?

Similarly, on Polish martial law, the European view on this was that it did not threaten Western security or Western interests; it was happening within the Soviet bloc.

So it seems to me it's hard for us to agree with our allies on what does represent a threat to Western interests, other than a direct Soviet attack on Western Europe.

Moderator HARDT. Can we add that to the agenda?

Dr. STENT. We can add that to the agenda.

Dr. WOLF. I have a number of points I would like to make, but I can't treat all of John's agenda because some of the questions are just too difficult.

But on his first question, would we be asking the Europeans under these rules of the game to change their worldwide policies on trade, I think the answer is "no," at least not initially. We would be only asking them to change their policies on East-West trade. But that would be permissible under GATT, as I read it or as it can be interpreted.

Let me support one point John made and then go on to some very quick comments on some of the points raised by the other panel members.

One lingering comment on the pipeline. I certainly don't think that either the way the sanctions that were initiated on June 18, 1982, or the way the sanctions were removed last month, was handled with proper consideration for the sensitivities of our allies and of world opinion generally.

However, I think, as John put the point in, it is true that our allies are at least listening now. We have gotten their attention, and whether that was by design or inadvertence, I think it facilitates, or at least creates the possibility for, some serious discussions in the months ahead that were not previously available, and were not indicated by their nonresponsiveness to the Buckley mission, or to the Versailles agreement in June. So much on the pipeline.

On Mr. Reichert's points about the effectiveness of sanctions and the view that they would have worked if our allies had gone along with us, I think that really is nonsense. I think they would not have worked in terms of affecting the Soviet invasion of Afghanistan after the fact. To think offensive, seems to me quite unrealistic. I think that there is a fallacy in expecting for much of a policy impact from any single instrument.

If you use as a criterion of whether instrument A, B, or C is effective, whether it will reverse a commitment of Soviet invasion forces, I think that is an unrealistic test. I think the question of whether sanctions or other instruments work is whether they add enough in the way of expected costs so that repetitions of such egregious actions are a little bit less likely to occur in the future; that is, whether they have a marginal disincentive or deterrent role.

On the point that he made that if we were to try to help the Soviet military capabilities by fully opening trade and technology transactions, it wouldn't have much effect in enhancing the Soviet threat because that is not dependent upon its technology, but only upon the state of the Western alliance.

I think that is plainly wrong. Many of the issues having to do with the basing for the MX missile, or with Soviet antisubmarine warfare, or antisatellite capabilities, are directly related to technology. And some of this technology is conveyed through civilian nonmilitary or dual use types of exchange. So I think that ought not be left in the record unchallenged.

On Mr. Reichert's doubts that removal of subsidies would have much effect on trade volume because of declining marginal costs and the opportunity for price discrimination by European suppliers in particular transactions, I don't know the answer to that question.

If you look at the sort of calculations we have made at Rand, the volume of subsidies on West-East transactions over the last several years of the decade of the 1970's works out to something in the neighborhood between $1 and $2 billion a year. And those numbers are not included in the net debt outstanding; that is, the net flow of resources from West to East. So what one would want to look at is the elasticities of trade volume with respect to the reduction of those subsidies. I don't know how large this elasticities are. This is an important question to investigate.

Incidentally, the benefits from those subsidies don't accrue entirely to the Soviet Union. Some of them accrue to the export sectors in Western Europe to the detriment of the taxpayers and voters in the larger scheme of things. So the question of whether reducing that billion or billion and a half dollars of annual subsidies, would be 5, 10, or 50 percent on trade volume is one I don't know the answer to, but I think that is a case where further analysis would be worthwhile.

The last comment I'd make is to focus more attention on unilateral courses of action, and this is probably where I differ from all of my panel colleagues, including the chairman, and probably with most of the members of the audience. By unilateral action, I do not mean a preemptory, arrogant posture. What I mean is to explain to our allies the reasons that make at least a plausible and understandable case for what we propose doing, whether or not they go along, and to express at the same time our understanding of their divergence.

Such a second order agreement is where each party has an agreed statement of the position with which he disagrees. I think it is important to seek second order agreement in cases where we are contemplating unilateral actions relating to economic policy, or relating to Mideast policy, or relating to Latin American and Central American policy. The angle of the lenses through which the United States has to view international problems is much wider and ought to be much wider than that with which the Europeans view those problems. So we should expect divergences within the alliance on a whole range of major international policy issues Where I differ with Mr. Sloan is in thinking we can insulate the alliance from excessive damage and repercussions in other domains with which the alliance is not centrally conceived.

I think the alliance may be on the verge, perhaps in the next year or two, of agreement on a coordinated Western military strategy, which we don't want to get into in this panel. I think it would be really a grave shame if divergences on what are from the standpoint of the NATO Alliance secondary matters—namely, economic policy, Middle East policy, Latin American policy, Third World policy—interfere with the fundamental prospects for an agreed, coordinated Western alliance policy on military strategy, which should be the alliance's principal concern.

Moderator **Hardt**. Just to continue to keep the record clear, the issue of net resource transfer being equated with credit, which came up in the hearings as well, is something that needs further discussion. Also, the question of the current creditworthiness of the Soviet Union being equated with an assessment of their balance of payments in hard currency and their potential future earning capabilities is a subject that needs a bit more airing. If we can get to that, fine. I would like to put it on the record and include some exchange with you on that, if I may.

Dr. **Stent**. I will just say a couple of things quickly in partial response to some of your questions. I won't get into all of these intractable economic questions. Those I leave to the economists.

On your question of what assumptions we are making about the Soviet Union, and to go back to the question I was asking Mr. Reichert before, the Europeans do not see the Soviet Union as much of a threat as we do. The Europeans tend to be much more aware of Soviet insecurities. They have more vivid memories of the last war and what this cost the Soviet Union.

So although there are Soviet troops on the German border, although the Soviets are much nearer the Europeans and the Europeans have to confront the Soviet military buildup in Europe much more immediately than we do, they do have a different perception of the Soviet threat than we do. This is partly because we have different global interests that Dr. Wolf alluded to.

So politically we have a difference of opinion with them as to how much of a threat or how immediate a threat the Soviet Union represents.

Second, there is the question of what it is we would like to see happen in the Soviet Union economically. If we, indeed, have any impact on the Soviet economy—and that is very questionable—there are some people in this administration who believe it should be our purpose to pursue a long-term strategy of economic denial toward the Soviet Union and possibly to promote an economic crisis there. Some people might even agree that we should try to promote an economic collapse there. At a minimum the administration argues that we should do nothing to help the Soviet economy overcome its problems.

By and large, Europeans do not share this view. They still believe that a fat Communist is less dangerous than a thin one, or to use another metaphor, since we always use metaphors about bears, that a hungry bear with missiles is more dangerous than a satiated bear with missiles. And there is still a belief in Europe that it should be our strategy to help the Soviet Union develop economically although not in its military sector. This might give the Soviet Union a continued stake in stability in Europe, because trade with Western Europe is important for the Soviet economy and it may deter the U.S.S.R. from taking military action toward Europe, that would disturb our allies.

So parts of the administration have a disagreement with the Europeans on our ultimate economic goals toward the Soviet Union, and also a disagreement about how much we can affect the Soviet economy.

Now to your last point about the exchange rate between politics and economics and whether if we were to go somewhat further toward the German position on East-West trade they would support our nuclear policy move explicitly. With regard to the NATO two-track decision, would they be even more willing to deploy the intermediate range missiles if the negotiations in Geneva don't work out?

I am afraid I think there is only a negative exchange rate here; there isn't a positive exchange rate. The pipeline sanctions did make the Germans more wary about supporting us in other areas so they had a negative effect. I think the reverse isn't true. These are two issues of such a different order of magnitude. The German population as a whole is very involved in the peace issue and the anti-INF missile issue.

They are not involved on such a mass scale in the East-West trade question. Even if we were to support the German Government more on East-West trade questions, I don't think this would have a positive effect on what happens to the decision to deploy the missiles, because you cannot establish an exchange rate in hard or soft currency between the East-West commercial issues and fundamental security-related political issues like the deployment of missiles, which evoke very different emotions and engage diverse political constituencies within Europe, particularly within West Germany.

Moderator **Hardt**. I think the definition that Dr. Wolf provided of economic warfare and economic realism is differentiated from what Angela is referring to, which may be called a policy of isolation or economic denial, in the long run. And if that is a distinction that you share, I think it is a distinction of considerable importance, because it does represent quite a different policy.

Mr. **Sloan**. Three very brief comments. Actually, one comment before the three brief comments. Concerning all these references to Dr. Sloan, I should make it clear that I'm not a doctor. An official in the most recent Dutch Government claimed to have all sorts of degrees and expertise and so forth and it was found out he didn't have any of those degrees and he left the Government. I don't want to leave CRS, so I will make this clear: the doctor is very complimentary but inaccurate.

With regard to Mr. Wolf's comments concerning the desirability of second order agreement, I think, in fact, although I may not have said so precisely, I would be inclined to agree that a second order agreement is perhaps what we should shoot for on issues where a first order agreement is too disruptive or difficult.

That doesn't mean I necessarily would agree with how Mr. Wolf thinks U.S. policy should be shaped within the context of second order agreement with the allies, but I do think that this is one way of protecting the heart of the alliance from issues that may be perhaps a little more on the periphery of the alliance.

However, I would say that if the administration's intent was to use the gas pipeline sanctions as a two-by-four, Dr. Hardt's description, that looks like an attempt to reach a first order agreement—in other words, to bring the allies into line with U.S. policy. So I agree with your stating that, in this area, it might be better to seek a second order agreement, and I will leave it at that.

Second, as to whether we can insulate the alliance, I think we can attempt to insulate the alliance from disagreements that may be on the periphery rather than at the center of the alliance, but I don't think we can insulate perceptions. And that is what I was talking about—the perceptions of the Europeans about the objectives and inclinations of the Reagan administration. Perceptions of how the Reagan administration behaved in one area might affect perceptions of how it was behaving or acting in another area. And I think it is hard to insulate perceptions.

Third, with regard to your comment that we may be approaching a new coordinated military strategy in the alliance, I would simply suggest that there are a lot of new and interesting ideas about military strategy, but I think we are a long way from a coordinated strategy. A lot of the ideas depend upon extensive expenditures for conventional weapons and financially; I don't think the money will be there for a number of years anyway, certainly not in the short term, to produce the kind of switch to a conventional strategy that, in some ways, appears attractive.

So I would suggest that we have a long way to go down that road before we reach any new coordinated strategy.

Moderator **Hardt**. Let me continue to add issues. Dr. Wolf mentioned GATT, and I was referring to the GATT provisions in article

21 which provide for exceptions in reference to security. But to my reading, there are no bases of exceptions for unilateral sanctions on the basis of foreign policy criteria. That might be an issue we would like to look further at.

Also, the question of leadership raises the question that the Germans so often raise, that is shared responsibilities. Leadership and consultation are one thing; shared leadership, shared responsibilities, and shared consultations are another. Is that policy a possibility? Is this something that should be given more attention because of the change of power in Bonn and Moscow and because of the differences of perceptions?

Now, you must answer all the questions. [Laughter.]

By the way, I should point out to Dr. Sloan that the graduate facility at Rand now has a degree awarding capability, as I understand it, and the dean at the other end of the table here is someone you should keep in good communication with.

Mr. **Reichert**. I think I've pretty much lost track of all of John's questions, and even if I had track of them I think my colleagues on the panel have done a marvelous job of responding to them.

One point I would like to make on John's intriguing concept of an exchange rate on issues, I definitely agree with Angela that there is a very serious possibility of a negative exchange rate. There may be a snowballing effect, a cross-issues, rather than a tradeoff effect.

On the other hand, I think that there might be another aspect of it that John may have been referring to. To what extent will the allies trade off issues where perhaps sovereign interests are divergent but weak in comparison with alliance interests, which may be relatively strong? I think there is some room for negotiation in such cases. There are times when the allies will accept policies which may be, to some extent, costly to themselves. To some extent, an ally must be willing to sacrifice its own particular interests for the sake of the alliance's interest. That is the fundamental basis of an alliance.

Now before Dr. Wolf leaves, I do want to apologize, because apparently I was, in my brevity, somewhat misleading with regard to my attitude toward the Afghan sanctions. In no sense did I want to imply that I felt there was an opportunity for the West, through any means, to reverse Soviet policy in Afghanistan.

My point is that the role of sanctions is not best understood in terms of economic costs to the Soviets. The role, I think, is better understood in terms of the information it carries to the Soviet Union, and I think that the information that we carried to the Soviet Union after the Afghanistan invasion was pretty poor and pretty unclear. But I think there was some information carried, and that was that the United States really did not approve of the Soviet invasion. It's not clear the Soviets understood the strength of that feeling. That reflects a breakdown in diplomacy as well as a failure of the alliance.

But my point on Afghanistan is that I think it is misleading to still think of sanctions in terms of imposing costs upon the enemy as a basis of applying a deterrent which will then alter behavior. I don't think that the economic costs of sanctions can be evaluated in any sort of predictive way that will tell you what their effect will be on behavior, because the political issues or the political costs overwhelm the economic costs. That is why I referred to the sanctions as carrying information rather than imposing costs.

The other important aspect of sanctions in the Afghanistan case is strictly internal to the West. When the Soviet Union invaded Afghanistan—and this gets to Dr. Stent's point as well—it was clearly a violation of U.S. international interests. The problem here is there is a structural imbalance in the alliance because of the United States is a superpower, a global power, and the Europeans, whether or not they really are, they have at least abrogated that responsibility to the United States. So there is a divergent interest problem to deal with. But nevertheless, once the Soviets invaded, the United States and/or the West as a whole had to respond somehow. There was a political need domestically and between the allies to do something. You can't just ignore the fact that the Soviet Union walked into Afghanistan.

So there was a symbolic political need to do something in response to the Soviets' adventurism, or aggression, in that case. And the question is, what do you do? That was the question posed by Dr. Stent. And what I am suggesting as an answer is to develop a regime, or at least a principle, for imposing limited sanctions as a means of symbolically satisfying the need to do something, satisfying the need to respond—and as a means of finding some way that you can get the allies together on an affordable basis.

Now, with regard to Dr. Stent's point about the West European distinction between security issues and economic issues, I'm not sure it is strictly binary in that regard. It's not yes or no. There is room, let me submit, for negotiation of agreement within the alliance; some sort of coordinated response is of interest not only to the whole but to the individuals. And you could get the allies to respond as long as you did not ask them to bear too much of a cost.

There will still be situations where the United States feels there is a violation of global interests and our allies do not, and we simply cannot bargain an agreement, no matter how cheaply we provide it to the allies. Either that is a clue to the United States that the problem is not severe, or it's a clue to the alliance that there is a fundamental failure in consensus there. Obviously, that is a case-by-case problem.

I also wanted to respond to Dr. Wolf's other comment about COCOM and my thought experiment. Again, I was at fault there for being too casual. I don't want to imply that the Soviet Union is not capable of using our commercial technology to its military advantage. But again, I want to submit that if the Soviet Union wants commercial technology, they are going to get it.

Now obviously, if you sell them 100 IBM 3300 series computers, it will be easier for them to implement such technology than if they have to steal one through Austria and replicate it. But the key question there is what is the real impact on the Soviet threat. I don't want to deny the advanced technology questions, but I want to clarify that point.

And finally, clarifying Dr. Wolf's concerns about subsidies, I want to point out I agree absolutely with him. The West should not be subsidizing the Soviet Union. My point about the marginal pricing was that that point should be made. It's trickier than it seems. It's not just a matter of government subsidies or credit for trade.

Moderator HARDT. The panelists have had a chance now to add their comments to each other's comments. I would like to open it to the floor, but before doing that I would like to add a couple more additions.

One has to do with COCOM, the points that Angela Stent raised, and to point out that the issue of critical technologies has to do with controlling industrial processes as well as industrial products. Industrial processes are cast in a broader scope of dual use, which goes pretty far toward limitations on all exports that will influence industrial potential.

Now, that phrasing of it makes it much more contentious as far as the French, Germans, and British are concerned, in terms of reaching a common view on COCOM. Dr. Wolf's formulation of the null hypothesis and the other two alternatives in terms of influencing Soviet behavior are very interesting. A very important caveat he makes is we should be sure that when we talk about Soviet behavior, we realize that we don't have a lot to go on in terms of being sure what Mr. Andropov will do, or how he perceives or values things. And that is a very important caveat to underline.

However, in his null hypothesis, doesn't he suggest that we should not assume that they will be either influenced one way or the other and, therefore, come down with a view that one hears very often in Europe. And that is, trade is separate from politics. I'm sorry he's not here to respond to that, but we will send him a copy of the record.

Yes, Francis? Francis Miko. Would you identify yourself so we can keep track on the record.

Mr. MIKO. I just wanted to make one point on Mr. Reichert's approach to sanctions policy. I think it is very relevant here to bring in Mr. Jenkins' statement from yesterday on the importance of proportionality.

As Mr. Reichert says, one could argue that the main purpose of sanctions is informational, but in that case, what information do you want to provide? It could be argued that if you reach too low a common denominator, you might send the wrong information to the Soviets. You may send them a signal that you are not willing or able to do much of anything.

So the question is: What do you want to achieve with your sanction?

Mr. REICHERT. May I respond?

Moderator HARDT. Yes, please.

Mr. REICHERT. Did everyone hear the question? No? I guess Mr. Miko's question was if you try to achieve consensus through the least common denominator, what real impact can that have if that least common denominator approaches zero? Is that a fair restatement?

Mr. MIKO. Yes.

Mr. REICHERT. I would like to think of it as the greatest common denominator rather than the least in terms of identifying an area of consensus that represents a maximum degree of consensus you can gain.

Now, I agree with you absolutely. If that is virtually trivial, then you have very little impact on the Soviet Union and you may have a negative impact within the West if you negotiate away a lot of political capital just to achieve some level of consensus, and that level of consensus is virtually worthless. Then I would agree you should not undertake an action that politically and economically is going to be more costly to the West if it appears that that level of negotiation is going to be detrimental because of the fact it approaches zero.

I would submit, however, in the case of some of these issues you are not going to approach zero; that there is a basis for some reasonably significant information you are providing the Soviet Union to the extent that you demonstrate that the West is able to negotiate together, is able to act together and is able and willing to undergo some level of cost in response to the Soviet Union. Then you are conveying real information, and merely by having demonstrated that capability, you have shown the Soviets—whereas, you haven't shown them now—that you can achieve a joint negotiating position.

So that, to some extent, is fudging your question, but I am trying to be realistic and suggest that we consider this different approach.

Moderator HARDT. Angela?

Dr. STENT. I hate to dissent from this, but I think the main information we sent to the Soviet Union in the Afghanistan and Poland sanctions was that the United States and its allies couldn't agree on them. And as someone said yesterday, we, the West, have done more to support and promote the Soviet goal of dividing Western Europe and the United States through these sanctions than anyone in the Kremlin could have dreamed of.

You must be very careful about what information you are conveying. If the major point of the information is how much at odds we are with our allies on achieving a consensus on sanctions, then maybe it is better not to try.

Mr. REICHERT. Yes.

Moderator HARDT. Another point that Kempton Jenkins made that is relevant to our discussion is that in the Afghanistan sanctions we indicated that military and political actions were to be excluded and moved entirely to economic actions. Now, during the pipeline sanctions we have moved toward stationing of Pershings in Europe, the increase of the NATO defense capabilities and, in effect, operated simultaneously on the military, political, and economic side. Now how you relate these is another interesting question, and I think it does go back to the question of interrelationships. Whether you use an exchange rate or not, there are interrelationships. Yes? Peter Sharfman.

Mr. SHARFMAN. This is a gloss on what Stan Sloan said, which I think may apply as well to some of the questions raised by others.

One way of interpreting the history of NATO is that in its good years, the members of the alliance have placed a higher value on unity, on agreeing with each other, than they have on the precise substance of their agreements. The basis of NATO's original military deterrent was the belief that the Soviet Union might dare to attack the Western European countries one at a time or even Western Europe as a whole, but would not dare to get into a conflict with all of the members of NATO at once. Thus, NATO unity was felt to be a significant deterrent, even before NATO built up any substantial amount of integrated conventional forces on the continent. Since then, there has been a feeling that the Soviet Union would not be willing to push too far a marginal military edge, provided that there was a unified alliance opposing it.

Now, if one takes that as a central feature of NATO policy, then a lot of the disagreements within NATO over the years can be phrased in terms of disagreement on how wide the scope of the central core of agreement had to be. One could trace back through 30 years or more a series of disagreements, for example, on policies outside the North Atlantic area, for example Middle East policy or policy with regard to Vietnam that has consistently demonstrated that NATO is unable to get agreement about foreign policies outside its geographical zone, and also that NATO can survive very well without such agreement.

COCOM stands as a demonstration over the years of a sense that on the issue of trade in directly militarily related items, agreement is necessary, and there has been a willingness, even when it hurts, to harmonize policies, even though one country or another in COCOM has often felt that the COCOM consensus was simply wrong on some particular matter. But still, sticking together has been more important than the outcome of particular decisions.

Now there has obviously been disagreement over the years about whether it is important to have a unified NATO policy on trade in primarily civilian items, or on trade in dual-use items with a large civilian component. In this context, one could view the sanctions as a U.S. assertion that there has to be some unity on such trade.

From this point of view, the sanctions can be seen as a demonstration of learning on the part of the United States, because if one looks at the debates back in 1979—with which I am familiar because we at OTA [Office of Technology Assessment] were doing a study in 1979 on technology and East-West trade—there was a substantial body of American opinion that it was possible to have a meaningful U.S. policy on East-West trade without first reaching agreement with our allies.

Thus, we might say that NATO now has, if not a second order agreement, perhaps a third order agreement that no one in the alliance can have a really effective policy in this area for long without some consultation with the other members of the alliance. That is still a long way away from a first order agreement on what that policy should be.

Now, in this context I think one might reinterpret Mr. Reichert's comment about what constitutes a diminution of the Soviet threat. If the opposition to the Soviet threat is primarily unity of the alliance, then it is in fact more important that the alliance be unified than that the Soviet military be somewhat less strong or somewhat more strong that it otherwise would be. And if that is Mr. Reichert's point, it is a good point.

On the other hand, if the Soviet threat has to do with fighter planes and tanks and missiles and submarines and things like that, then there is simply no basis for supposing that the Soviet military would not be stronger if they had unimpeded access to Western technology. One can compile a long list of Western technologies which would strengthen the Soviet military if they were free to come and buy them. For example, the jet engines hanging on the wing of a 747 would give Soviet bombers longer range and longer loiter time than they have now. It is clear that the Soviets don't make such fuel-efficient engines because they don't know how.

So we must distinguish between the question of the Russian threat, and the question of the effectiveness of the NATO posture opposing that threat. We must accept the fact that a particular kind of action, for example, pressing very hard to restrict trade with the Soviet Union, may simultaneously diminish the Soviet threat and also diminish the alliance's ability to deal with that threat by creating a considerable degree of disunity within the alliance.

Mr. SLOAN. I would like to thank Peter Sharfman for adding some additional historical perspectives on the alliance and suggest perhaps that there is an important relationship between the desire to broaden the area of consensus within the alliance and the attempt to force agreement on East-West trade policy. The basis for consensus within the alliance, which worked for a number of years, started with the articulation of what was called the Harmel formula in the mid-1960's which combined defense and détente policies into a political framework that allowed NATO to reach agreement on a lot of things, or at least put a lot of issues within that framework. That framework has fallen apart.

The Europeans still accept it. But we don't accept it entirely, and if you look at NATO communiques today instead of defense and détente you see defense and genuine détente. So the fact is that we have been attempting to reach an agreement on East-West trade policy—which has not previously been regarded as a top priority for consensus among the NATO allies—at a time when we have yet to reestablish the broader political basis for agreement within the alliance. That makes the effort doubly difficult.

Dr. STENT. Maybe I am wrong, Stan, but I thought when I was reading the communique last week from Brussels where the United States and its allies had agreed to pursue a two-track policy toward the Soviet Union, it sounded to me as if the United States was reaffirming the principles of the Harmel report, or did I not read that carefully?

Mr. SLOAN. They have never been done away with. It's just that politically, they don't have the same effect they used to of providing a framework within which to operate. I think you will find the word "genuine" is in there and has its own meaning.

Moderator HARDT. Ambassador Dean?

Ambassador DEAN. I would like to also refer to some of the things that Stan Sloan and Peter Sharfman have brought up. Stan's remarks I think reflect the fact, which is very germane to your discussion here today, that for the past 20 years, there has been a steady attrition of American dominance in both the military and economic fields. And parallel with that, there has been what I would consider an even more serious attrition in American prestige and influence, which is not a mere reflection of the decline.

It's hard to measure a matter of this kind, to measure a loss of influence. We here in the United States probably think this loss is less. Our allies probably consider it to be more than prevalent opinion here might have it. But this shift does argue—and that is the message that I get from Stan's remarks—for a different style of American leadership, with more effort to persuade our allies.

I don't think we can exercise leadership in this project and in others by following Mr. Nixon's prescription of seeking to impress people with our irrationality, or the Italian method of drawing attention by tantrum, which does draw attention but does not produce leadership or influence.

It seems to me it has not yet emerged from what has been said here that economic policy of NATO and NATO military policy are, of course, aspects of Western policy toward the Soviet Union in general and not separate things. If we want to resolve the differences here which have been referred to by your panelists, we will have to work long and hard to achieve a slightly higher degree of consensus in NATO on overrall policy toward the Soviet Union.

But the target is a moving one. There is no stable Soviet Union that we are all trying to zero in on, and there is no very high degree of consensus, even within individual NATO countries, so I don't think that we can realistically hope for such a high degree of consensus that it will make unified policy readily possible.

Domestic politics, which have also not yet been mentioned, play an important role in this question of policy toward the Soviet Union. If the Carter administration had not been facing a Presidential election, its own reactions to the Soviet invasion of Afghanistan might have been somewhat more temperate and less vigorous.

Anyhow, one consolation is that U.S. relations with the Soviet Union will be long-lasting and have many ups and downs. There will be lots of opportunity for policy innovation. But I would say that what Peter Sharfman and what Stan said about the degree of push we give this project is, I think, well phrased. If the economic effects of a given trade policy or commercial policy toward the Soviet Union are uncertain, then it is certainly not worth risking the cohesion of the alliance for it. Moreover, present unfavorable economic circumstances, as I am sure was mentioned yesterday make the question of extending credits, government credits, rather academic.

I do share the view of Mr. Reichert that we will go further with our allies, get further, if we can make our policy of coordination a positive approach rather than a totally negative one of denial.

Thank you.

Moderator HARDT. John Danylyk.

Mr. DANYLYK. The consensus of the panel yesterday and today seems to be that the economic sanctions against the Soviet Union have been ineffectual in the sense that they have not changed Soviet behavior nor have they really impacted measurably on the Soviet economy, at least in any sense that they have hurt the Soviets more than the allies.

Today's speakers mentioned nevertheless we have the need to demonstrate to the Soviet Union that we in the West are dissatisfied with certain aspects of Soviet behavior. It has been brought out that there is a need to be able to send this message clearly to the Soviet Union.

In other words, if the Soviets are going to do something dastardly, they should expect to be punished. The punishment should be short-lived, perhaps. But how could we engage the allies in this effort and avoid the public bickering which detracts from sending a clear signal to Moscow when the situation calls for a clear signal?

Moderator **Hardt**. That is an important point, John. Bill Reichert made reference to the use of sanctions for sending signals. Certainly, there was wide agreement on the Afghan sanctions for sending signals, but when it came to punishment or, to use the terminology of the Reagan administration, to make them pay the price, that seemed to have been a divisive rather than unifying aspect.

Dr. **Stent**. I think if left to their own devices, if they did not have to listen to the United States, the Europeans would prefer not to send any kind of economic signals to the Soviet Union when the Soviet Union takes action of which they disapprove. This all gets back to the question of how much of a threat the U.S.S.R. represents, and both Afghanistan and Poland were not perceived to be a direct threat to Western European security interests, however regrettable they were.

In an ideal world the Europeans would eschew economic sanctions altogether. That is why it is a constant battle between us and the Europeans to get them to go along with us.

Now, of course, we have leverage over them, and we probably have the most leverage over the Germans because of their security dependence upon us. However, that leverage is somewhat diminishing and, therefore, we cannot assume that the Europeans think that this is the way to proceed. They consider that economic sanctions impose more economic costs on them than they do on the Soviet Union. And moreover, sanctions are politically divisive.

Mr. **Danylyk**. I did not mean to limit the idea of sanctions to just economic sanctions. But when some sort of response, some sort of measured response is necessary, how could it best be communicated, how could it best be agreed upon in advance?

Dr. **Stent**. I have heard some Europeans say, why does the United States not react with military means when the Soviet Union does something it considers a threat? Some of the things were even discussed yesterday by Kempton Jenkins, for instance more NATO exercises on the Yugoslav border, beefing up our troops. I would like to see the European response if we actually did it.

The other European argument I have heard is, why doesn't the United States selectively try to preempt the Soviet Union in certain areas, say, of the Third World instead of being in a position where it always reacts to Soviet actions? It could decide there are certain key areas in which it will get involved, say certain Third World countries, support various movements there, and try to prevent the Soviet Union from spreading its influence.

That is, of course, a good way for the Europeans to avoid the question of what they themselves have to do. But those are the kinds of suggestions I have heard from them.

Mr. **Sloan**. Who have you been talking to in Europe?

Moderator **Hardt**. She said it yesterday, so she is quoting herself.

Mr. **Reichert**. I realize that Dr. Stent knows a lot more about the politics of Europe than I. But I think it is worth pointing out that, as with the United States, Europe is not a monolith either, in terms of its point of view on these issues. One of the reasons the Europeans disagree so much with the United States is, I think, partly a function of bad management by the United States and partly a function of kind of natural irascibility, I guess, by the Europeans, especially the French.

But in terms of getting toward some sort of consensus, I think you can consider the possibilities in terms of what sort of costs you are asking the Europeans to bear and ask them how it compares to the possible gains. And the costs are made up both of real economic impacts on the Europeans of doing something whether it be militarily or economically, and part of that depends upon the duration of that action.

I also am not an expert on what happened in the Falklands, but I think there is a model there where the Europeans, with some clear differences among them, were nevertheless able to negotiate this temporary import embargo on Argentina. You still have the problem with whether that is significant enough to convey the information you want to convey.

I would contend that something along those lines is enough to send a positive signal both because of the demonstration effect within the alliance that is valuable—and I appreciate the gentleman's contribution back there—and because just having had that experience, if push comes to shove, it would be easier to escalate the impact of your response subsequently if the Soviets continue to misbehave.

At least in the Soviet perception, they would see that the alliance as greater capability to act in unison than if it is not able to do anything. So I think there is certainly value in trying that.

Mr. **Sloan**. Just a very short comment on Bill's Falkland's analogy. I think it is an interesting analogy, but not appropriate, perhaps, because it is a very good example of European solidarity but it does not address the question of Atlantic solidarity.

If you had tried to put together sanctions against Argentina on an Atlantic basis, the United States would have had problems in joining the European Community in their action. So I am not sure it serves as a good model for future action within the alliance. That decision did not have to deal with the problems that arise in the Atlantic context.

Moderator **Hardt**. That goes to Peter's comment in another way, and that is, on Afghanistan we had more agreement with the Asians, the Japanese, than we did with the Europeans, which raises another issue.

Eilene Galloway is next, and Dario Scuka, and then we will have to pull things together.

Eilene Galloway.

Ms. **Galloway**. It seems to me that the prevailing U.S. premise, operational premise, is that linkage is a good thing no matter what is being linked and whether or not the elements are relevant. If you link things that are relevant, I think you have some opportunity of figuring out the consequences of your decisions. But if you link things that are totally irrelevant just because you are going to punish somebody, then you are apt to create consequences you simply cannot estimate in advance.

So if the policy of the Government is to link things to the Soviet Union in order to punish them in one way or another, which would always mean that in every case you were more interested in the stick than the carrot, and if you have a lot of people, as they said yesterday, making decisions within the Government that affect this total situation—and they may be in the middle levels of the Government or in different agencies and they do not have an idea of the history of these different incidents that we have heard about that have not been cost effective in the United States—then it seems we ought to try to look at this premise of linkage and explain that in some cases it can be very good and in other cases it can have untoward consequences.

Moderator HARDT. Thank you.

Dario Scuka.

Mr. SCUKA. A few remarks concerning proportions in the issues under discussion. What we have established is the existence of a gap between people or groups who study and analyse prevailing international situations and, of course, the behavior and the actions and policymakers and their methods more often than not weighted ideologically. There is also a gap between American and European points of view.

I would like to pose the question of whether the Europeans are aware of the current attitudes of the administration concerning the change of leadership in the Soviet Union. For that matter, are we aware of the administration's policy, spelled out convincingly if at all possible, in terms of their ultimate goals? I would like to give you an example of what came to my attention yesterday.

Many observers see an opportunity in Andropov's assumption of leadership in Moscow. The transition of power took place in a rather positive manner; that is, the Soviets tried to assure the rest of the world that they too can smoothly adopt a change in government, dispensing belligerence, and suggesting that they are rather serious in acknowledging economic problems they face, especially problems in agriculture. There is even talk about the need of restructuring the Party apparatus with clear allusions to having not only a large problem of freeloaders, if I may use the expression, but also corruption, which has been freely admitted. A reputable advisory service that has consistently claimed and proven to be close to White House sources, wrote that Reagan intimates are not impressed by the signs Andropov has been sending to the rest of the world. Some skepticism is clearly in order, considering the seriousness of economic reforms or any other reforms that the Soviet Union faces. How serious or successful they may be is open to question, given past experiences. But recognition of a problem is a big first step.

White House insiders pointed out that they are not impressed by such opportunities because of previous experience surrounding the beginning of Khrushchev's era and the beginning of Brezhnev's era. They indicate that none of the positive or hopeful aspirations of those occasions have proven to be realizable. So the White House is now in a frame of mind that seems to exclude that Andropov's potentially positive actions will be realized.

Once that is said, in order to reinforce their position of uncompromising policy, as we learn it from newspapers or other sources of news, the same White House source added that after all, Mr. Andropov has failed to promise the most important change—and believe me, I read it straight—the administration expects that Andropov should announce a change from Party dominance in Soviet life as an acceptable message to the West for improved relations with this administration. Where is the realism in that? Where are the proportions between fact and fancy? Where is real politic?

Moderator HARDT. I think the point of the difficulty and the problem of accurately assessing Soviet behavior under a new leadership is something that should be given serious consideration. I do not think at this juncture in this workshop we will want to get further into that.

But I would like to return, as our time has expired, to the purpose of the workshop. Senator Percy, Senator Pell, and Senator Mathias have chaired hearings on East-West commerical relations in July and August, and they asked us to conduct this workshop in that continuum.

They were concerned about the effectiveness and appropriateness of the use of the pipeline sanctions in the narrow sense. But they were also concerned about all of the premises underlying our East-West commercial policy and, more particularly, our U.S. policy and trade with the Soviet Union. So we were charged with exploring these to try to structure the problems and provide policy insights.

And in the process, the President did on November 13 raise the sanctions and indicate that long-range studies and consultations are now underway among the major Western industrial economies, not just NATO but OECD. And these studies are underway with an idea that there will be some results at a certain time, such as this spring. And therefore, these activities, I think, will serve the further purpose of contributing from a congressional viewpoint to this kind of ongoing dialog.

We are also aware, as many of the people who have discussed these issues have pointed out, that the Export Administration Act is coming up in the jurisdiction of another committee and that this will be of considerable importance to the Members of Congress and committees. And there will be, I think, a fair amount of deliberation on these issues.

The recommendations that have been made by the workshop participants have ranged fairly widely, and their advice on our agenda is available for the Congress. Of course, the Congress, makes policy both by legislating as well as by influencing policy of the Executive through the congressional media.

I would like to thank all of the participants of the panel. I think for us at least it has been a very rewarding experience.

[Whereupon, at 12 noon, the workshop concluded.]

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